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AN INTERDISCIPLINARY JOURNAL OF PUBLIC POLICY ANALYSIS

FINANCIAL DEREGULATION IN A GLOBAL ECONOMY
PART I

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VOLUME 13 NUMBER 2 • PUBLISHED BY THE CATO INSTITUTE

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the CATO JOURNAL

VOLUME 13 NUMBER 2 • PUBLISHED BY THE CATO INSTITUTE • FALL 1993

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The CATO JOURNAL is indexed and abstracted in the *Journal of Economic Literature, Current Contents/Social and Behavioral Sciences, Social Sciences Citation Index, America: History and Life, Historical Abstracts,* and the **ABI/INFORM** data base. The CATO JOURNAL is available on microfilm from University Microfilms International, Ann Arbor, MI 48106.

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CATO JOURNAL • VOLUME 13 NUMBER 2 • FALL 1993

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EDITOR'S NOTE

The papers from the Cato Institute's 11th Annual Monetary Conference—**Financial Deregulation in a Global Economy**—are being published in two parts: Part I appears in this issue; and Part II appears in volume 13, number 3. Both issues are being published simultaneously. This decision was based on the large number of papers to be published and the importance of the topic. The papers originally scheduled for volume 13, number 3 will appear in volume 14, number 1.

—J. A. Dorn

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INTRODUCTION

Financial Deregulation in a Global Economy

James A. Dorn

> Restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or distort economic growth. Competition in banking, on the other hand, acts as a spur to the mobilization of idle financial resources and to their efficient utilization in commerce and industry. These conclusions do not arise from any doctrinaire attitude, but solely from examination of and reflection on historical experience.
>
> —Rondo Cameron (1972: 25)

Removing Barriers

Trade liberalization and the information revolution have paved the way for the globalization of financial markets. The pace of financial globalization, however, will depend critically on whether governments get out of the way of the market or whether they try to block the natural course of market forces by erecting new barriers to the globalization of trade and finance.

Like other institutions, financial institutions evolve best when left alone to respond to consumer choice. In an environment of free competition and private property rights, owners will be held accountable for the services they provide, whether those services be the provision of computer software or the provision of financial instruments. History has shown that "where banking was left most free to develop in response to the demand for its services, it produced the best results" (Cameron 1972: 25). Or as F. A. Hayek (1976: 22) put it, "The best the state can do with respect to money is to provide a framework of legal rules within which the people can develop the monetary institutions that suit them best."

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The problem is to get governments off the backs of banks and to let financial markets grow without the burden of excessive regulation. "The proper role of government policy should be to make markets as resilient and efficient as possible. Government policymakers should get rid of the traditional bottlenecks of overregulation, overtaxation, and overprotection, and let markets work" (Lindsey 1993: 168). In almost every country, the financial sector is one of the most highly politicized and regulated parts of the economy. "In no other sector of the economy, with the possible exception of foreign trade, have governments intervened so broadly, so consistently, and with such telling effect—usually bad" (Cameron 1972: 9).

Even though the United States has made a stab at financial deregulation, banks are still prohibited from interstate branching, from selling securities, and from mixing banking and commerce. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980; the Garn-St Germain Act of 1982; the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989; and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 have made marginal improvements in the regulatory climate, but those reforms have left a fragmented banking system and have added to the complexity of the rules and regulations governing financial institutions. Jay G. Baris (1993: 13), a financial services lawyer, writes, "Not even well-intentioned banks could comply with the thousands of pages of complex rules now in existence," the compliance cost of which is "estimated at up to $17.5 billion annually."

Removing barriers to a free market in financial services will not be easy, since "neither the public nor their elected representatives seem disposed to easing off on bank regulation" (Lindsey 1992: 2). Domestic financial institutions want to protect their turf from foreign competitors, community action groups want to have guaranteed access to cheap credit, and politicians want to ensure that they have ultimate control over banking and financial services. If existing barriers are to be removed and new barriers avoided, there must be a general recognition of the importance of market competition as a disciplinary force on financial institutions and an awareness of the costs of centralization and overregulation.

The contributors to this two-part issue of the *Cato Journal* address the need for financial deregulation in a global economy.[1] Emphasis is placed on the role of the legal structure in shaping incentives and

[1]The papers in volume 13(2–3) were first presented at the Cato Institute's 11th Annual Monetary Conference, "Financial Deregulation in a Global Economy," held in Washington, D.C., March 18–19, 1993.

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behavior. The laws that govern banking and finance and the approach taken toward regulation will determine the pace of financial innovation and the gains that can be realized from opening new markets (see Todd 1993). Volume 13(2–3) also considers the relation between the framework for monetary policy and the safety and soundness of the banking system. Monetary stability and financial stability go hand in hand. If there is no credible commitment to maintain monetary stability, and monetary authorities are not held accountable for failing to safeguard the value of money, uncertainty about the future value of money will be transmitted to the financial sector.

The challenge is to provide a stable framework for monetary policy and let financial institutions evolve naturally in response to the demands of the open market. In thinking about that challenge, one confronts the problem of how to depoliticize money and banking. As long as governments have the dominant role in shaping monetary and financial institutions, experimentation will be limited; opportunities to discover new ways to improve the institutional framework—for both money and banking—will be curtailed.[2]

Market Discipline versus Centralized Controls

Market prices provide incentives and information to guide decision-makers in the allocation of scarce resources. Insofar as markets are competitive and prices are flexible, resources will tend to flow to those uses deemed most valuable by consumers. Institutions that serve consumers best will survive; institutions that do not will fail. Thus, the market itself can act as a brake on inefficient institutions while encouraging the success of efficient ones.

If financial institutions were subject to global competition, if insolvent banks were allowed to fail, if deposit insurance were properly priced, and if monetary equilibrium prevailed, there would be little reason to expect banking to be inherently unstable.[3] Free entry and exit, full disclosure, and personal liability for risk-taking would motivate owners and managers of financial institutions to create wealth while safeguarding their customers' deposits. And placing limits on the

[2]According to F. A. Hayek (1989: 103), "Under government patronage the monetary system has grown to great complexity, but so little private experimentation and selection among alternative means has ever been permitted that we still do not quite know what good money would be—or how good it could be."

[3]Michael Bordo and Anna Schwartz (1989: 26) argue, "Banks are not inherently unstable, provided the institutional setting in which they operate and the incentives they are exposed to do not predispose them to excessively risky undertakings."

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creation of government fiat money would help achieve monetary stability. In such an environment, the market would sort out prudent and foolish decisions and, thereby, act as a disciplinary force on financial institutions (see Bordo and Schwartz 1989: 26–34).

A market-based approach to financial regulation would recognize the self-regulatory aspects of competitive markets and encourage sound institutions while allowing weak ones to fail. There would be little room for political maneuvering. Regulatory costs would fall "because markets are much more efficient at modifying banks' behavior than regulators could ever hope to be" (Jordan 1994: 315).

The globalization of trade and finance has tended to weaken the influence of government and to strengthen the influence of the market in determining policy outcomes (see Keleher 1993). If foreign exchange traders move against a currency—because they expect policymakers to increase taxes, enact trade restrictions, hamper capital flows, or spend recklessly and finance their spending with money creation—market expectations will rule, and the overvalued currency will depreciate regardless of government intervention to support it. Thus, markets will influence policymakers and lead to policies that are more in tune with market liberalism than might otherwise be the case. Consequently, one can predict that "increased globalization of the markets for financial instruments will reduce the exploitive potential of all governments" (Niskanen 1994: 339).

Governments, however, will continue to meddle in the market and try to centralize regulatory controls. The 1991 Basle Accord, which set international capital adequacy standards, was a step toward centralization and away from market discipline (Shelton 1994). Government decisionmakers dislike markets because markets deprive bureaucrats of their power over economic life. Free markets create uncertainty for those in power. Government decisionmakers, therefore, tend to be suspicious of the market and inclined to overregulate rather than to underregulate.

The tendency to overregulate can be countered by allowing competition among regulatory agencies (England 1994) and by allowing competition among regulatory rules across political jurisdictions (Keleher 1993, Lewis 1993). The United States could learn from Europe by adopting the principle of mutual recognition, whereby home-country, or home-state, banking rules would take precedence over host-country, or host-state, rules. If home-jurisdiction regulations

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were less restrictive than host-jurisdiction regulations, there would be political pressure to liberalize financial regulations in the host jurisdiction.[4] Policy competition would lead to the least burdensome regulations, and the overall compliance costs of financial regulation would fall. Countries and states would tend to harmonize their regulatory policies via the competitive process rather than through centralized control. Moreover, unlike centralized policy coordination, "policy competition among decentralized policymakers . . . is fully compatible with the operation of the price mechanism and fosters regulatory experimentation and innovation as well" (Keleher 1993: 281).

Trying to plan the process of financial globalization from the center is impossible. Centralized control will hinder, not foster, the development of global capital markets and the spontaneous emergence of new financial instruments. If the United States is to fully participate in the financial services revolution, policymakers need to recognize the limitations of government regulation and come to a better understanding of the benefits of open competition.

The growth of financial regulation in the United States is not encouraging. "Congress has overreacted to the S&L collapse by an extraordinarily complex web of new regulations on the premise, apparently, that if some regulation is desirable, more regulation is even better" (Niskanen 1994: 339). Policymakers also have started to shift attention from regulations designed to promote the safety and soundness of financial institutions to regulations designed to promote "fairness" via centralized credit allocation (Lindsey 1992: 3). If credit allocation becomes a reality, financial markets will become more, not less, politicized, with dire consequences for U.S. capital markets.[5]

Safe and sound banking is not obtained by socializing risk via federally subsidized deposit insurance, nor is it obtained by prohibiting

[4]Robert T. Clair and Gerald P. O'Driscoll, Jr. (1993: 42–44) discuss the principle of mutual recognition as applied by the European Community. The principle "constitutes home-country control over banking regulations" and "guarantees that each EC member state recognizes the rules and regulations of the other members" (42). Clair and O'Driscoll (44) contend that Europe's adherence to the principle "will facilitate and hasten the liberalization of banking regulation compared to the slow pace in the United States." Unless the United States reforms its outmoded regulatory climate, "Europe, or at least the European Community (EC), will have freer trade in banking (and other services) than will the United States." See also Lewis (1993).

[5]Federal Reserve governor Lawrence B. Lindsey (1992: 3–4) states: "One could envision credit rules allocating the types, volume, and location of loans that banks could make. One could also imagine racial, ethnic, income, and geographic guidelines regarding the recipients of those loans. A shift in the regulatory framework in this direction is not inevitable, nor, however, is it inconceivable."

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interstate branching and limiting the scope of banking activities. The surest route to safe and sound banking is not through centralized control but through privatizing risk, full disclosure, open markets, and a limit on the discretionary power of central bankers and regulators (see Kane 1994). Central planning and market socialism have failed elsewhere; why should we expect them to be successfully applied to money and banking?

Financial Stability and Monetary Stability

It makes no sense to talk about financial stability without talking about monetary stability. Banks and nonbank financial institutions operate within a specific monetary regime. If that regime is unstable, as evidenced by erratic variations in the quantity of high-powered money and an uncertain price-level path, the financial system will be adversely affected. That is why Bordo and Schwartz (1989: 33–34) have concluded:

> Price-level stability in our view is a prerequisite for safe and sound banking. If the price level is stable, any mistakes that banks make in acquiring assets will be attributable to faulty credit analysis, not to price-level or inflation surprises. If the outlook for future price-level stability is doubtful, the success of a self-regulated banking system is also doubtful.

The discretionary, fiat-money regimes of today do little to create confidence in the global financial network. Typically, monetary authorities pursue multiple objectives and are not held accountable for failing to achieve price stability.[6]

W. Lee Hoskins (1993) points to the need to rethink the framework for U.S. monetary policy. He wants the Federal Reserve to be held accountable and to be constrained by a monetary rule that will result in zero inflation over the long run. The problem is to effectively constrain the Fed in an environment that is politically charged and in which the government has a monopoly over the creation of high-powered money. Will the Fed give up its discretion and commit to a policy of zero inflation? Can it be held accountable? And, if so, for how long?

Lawrence H. White (1993) is skeptical about the possibility of any central bank sticking to one objective and giving up its discretionary authority. For him, as for Hayek (1978), the best path toward monetary

[6]New Zealand is an exception. The central bank is committed to zero inflation and the governor can be fired for failing to achieve the inflation target (Fischer 1993).

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stability is free banking with competing private currencies. If that path is not politically feasible, one should at least make sure that the central bank's power to print high-powered money is limited, either by freezing the monetary base (as proposed by Milton Friedman [1987]) or by limiting its rate of growth by adopting a feedback rule to stabilize nominal income (as proposed by Bennett McCallum [1984, 1989]).[7]

Regardless of the rule chosen, there needs to be a monetary constitution that fosters the predictability of the future path of the price level and of the monetary regime within which financial institutions operate.[8] Predictability would make property rights more secure and increase the efficiency of the price system. Banks would make their investment decisions without the threat of unexpected swings in the value of money, and relative prices would convey more information without being distorted by monetary shocks.

Evolution of the Global Economy

The integration of the global economy has not been planned; it has evolved through a competitive market process. Governments have intervened, but markets have responded by circumventing regulations and creating new financial instruments, such as derivatives, and new financial institutions, such as nonbank mutual funds. Since their creation, the new instruments and institutions have evolved rapidly and pretty much spontaneously. If this evolutionary process is to continue, however, institutions and markets must be allowed to grow without the threat of government intervention.

Experience has taught that international economic coordination is best achieved by decentralized rather than centralized decisionmaking. In a regime of floating exchange rates and independent monetary authorities, major trading partners are free to pursue price stability and constrain the growth of government spending. If, instead,

[7]McCallum's feedback or adaptive monetary rule would provide for changes in the monetary base to achieve a target growth path for nominal GNP consistent with long-run price stability.

[8]James Buchanan (1962: 156) regards "*predictability* in the value of the monetary unit" as the key criterion for judging a monetary regime and emphasizes the importance of a monetary constitution in achieving that predictability. (See his section on "Predictability and Constitutional Attitude" [180–83].)

Peter Bernholz (1986) also emphasizes the importance of a monetary constitution. He advocates a genuine gold standard and free banking as his preferred alternative to achieve predictability. He would "abolish the central bank, institute a pure gold standard, and allow free banking. The monetary constitution would only postulate that each creditor had the right to demand payment from each debtor in gold at the fixed parity. Any violation of this rule would be severely punished by private and/or public law" (498).

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they choose inflation and increased spending, they must bear the consequences.

There is no reason to believe that economic integration requires monetary integration. The European common market does not necessitate a single currency and a European central bank. As Anna Schwartz (1993: 277) notes: "Free trade is achievable without fixed exchange rates or monetary union. Fixed exchange rates have economic costs, and monetary union is a political pipe dream."[9]

Yoshio Suzuki (1994) cites the experience of Japan in the late 1980s as an example of misguided international coordination. Instead of adhering to a noninflationary monetary policy, Japan was pushed into an expansionary policy by the 1987 Louvre Accord, which was designed to lower interest rates in Japan and strengthen the dollar against the yen. The expectation of lower interest rates inflated asset prices in Japan until the asset bubble burst in 1990, after a series of increases in the interest rate. The lesson for Suzuki is that leading economic powers like Japan and the United States should "have autonomy in their economic policies." If either economic superpower "sacrifices its domestic stabilization policy for the benefit of the other superpower, the resultant domestic destabilization will eventually cause serious harm to global stability" (449).

The smooth evolution of an integrated world economy will stem not from forced international coordination but from policy competition among sovereign nations. Each country seeking to liberalize and stabilize its own domestic economy will help liberalize and stabilize the global economy. A decentralized, competitive approach to global policy coordination is useful because it allows countries to discern policy mistakes and to discover the most beneficial policy mix (Vaubel 1986: 41).

International coordination works best when it is voluntary and there is a general appreciation of and adherence to a common set of rules that limit the power of governments to tax, spend, regulate, and print money. A rules-based approach to macroeconomic policymaking and a competitive approach to regulatory policymaking will help promote economic liberty and achieve domestic and global stability.[10] Continuation

[9]Compare Lewis (1993). He argues that common markets are facilitated by common currencies and that "fixed exchange rates are not necessarily at variance with free markets and offer many of the benefits of a common currency, but only if they can be maintained credibly" (270).

[10]Robert Keleher (1993: 285) examines alternative approaches to international policymaking and concludes: "Virtually the only examples of persistent successful policy coordination or harmonization are . . . the policy competition approach and the common rules approach. Both approaches are fully compatible with the workings of the price system. Consequently, as the world becomes more integrated, these may be the only truly viable policy alternatives."

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with a discretionary policy regime—with government fiat money, managed trade, pegged exchange rates, excessive government spending, overtaxation, and overregulation—will only frustrate the natural evolution of the global economy and further politicize economic life.

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Economic Challenges of the 1990s

Lawrence B. Lindsey

A Rule for Handling Economic Challenges

The United States has just been through a very extraordinary period in its economic history, in the number of economic challenges that it has had to face and digest in a relatively short period of time. I think if there is no sound rule about how to handle those challenges, we should make one. The rule ought to be that there is a limit to the capacity of any economy to handle economic dislocations. Moreover, when those economic dislocations and challenges occur at a rapid pace, it is only natural to expect that the efficiency of the economy will diminish.

Three Economic Challenges

Several economic challenges need to be emphasized, and all are of an international character: (1) the challenge of coordinating international banking regulations; (2) the challenge of lowering inflation in the G-7 countries; and (3) the challenge of adjusting to the post-Soviet international order. There are other challenges, but I think these three give a flavor of just how dramatic the changes in the past few years have been.

Coordinating International Banking Regulation

In the mid-to-late 1980s, it became increasingly apparent that the nation-state based method of banking regulation, which had been in place from time immemorial, was no longer sufficient to handle what was becoming an increasingly global banking market. In an age in which billions of dollars could travel overseas in a nanosecond, it became increasingly important for national regulators of banks to be

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The author is a member of the Federal Reserve Board of Governors. The article is based on his keynote address at the Cato Institute's 11th annual monetary conference, "Financial Deregulation in a Global Economy," March 18–19, 1993. The usual disclaimer applies.

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able to at least sing from the same song sheet. The demand to try to have some sort of international coordination in the way in which banking regulation was conducted was the impetus behind the meetings in Basle.

Without going into the details of the Basle agreements, one can conclude that whenever there is a change in the rules of the game, the adjustment costs are going to be high. Adjustment costs in the banking industry have been high not only in this country but around the world. The banking industry has had to change the method by which it does business and has had to take on a whole new paperwork burden, all in the name of meeting the new rules of the game. Moreover, because banking is the lifeblood, financially, of any economy, changes in the rules of the game that affect the banking industry will affect the entire economy, especially those sectors that depend on banks for financial support. Consequently, the adjustment to the new rules have reduced economic growth, both here and abroad.

The United States has largely completed the adjustment process. At the end of 1993, more than 98.5 percent of U.S. bank assets were in institutions that, under the new rules, were either adequately or well-capitalized, with the majority of assets in well-capitalized institutions. The transition, however, is still going on in some of our major trading partners, most notably Japan. Like the United States, those countries will face difficult economic decisions as they adjust to the new rules of the game.

Lowering the Rate of Inflation

The second challenge the United States faced was an international decision to lower the underlying rate of inflation. When I went to school, I was taught that there was a permanent tradeoff between inflation and unemployment. It was assumed that economic policymakers could pick the optimal policy mix and, if they were wise, they would pick a mix that involved moderately high rates of inflation in order to buy moderately low rates of unemployment. It was assumed that only unemployment, not inflation, was costly to the economy.

I think it is fair to say that the wisdom of 20 years ago is no longer the consensus view in the economics profession. It is certainly not the consensus view in central banks and finance ministries around the world. What we have come to appreciate in the last 20 years is that those countries that did not accommodate the oil shocks of the 1970s, with increased monetary ease, ended up doing better than those economies that did accommodate those shocks. We have also come to appreciate that there may be higher costs to inflation than what we previously thought was the case.

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One of those costs—the capacity to do long-term planning—is fairly hard to quantify. Yet, it should be clear that inflation affects such planning by making the future price level less predictable. Even an inflation rate of four percent means that the price level will double in 18 years, quadruple in 36 years, go up by a factor of 16 in a lifetime, and a factor of 50 in a century. How can we expect a 30-year old to plan for retirement when the price level at the time of retirement may be 10 or 15 times what it is today? Or how can we expect an electric utility or other major investor to plan to build a factory with a 50-year life when the price level at the time the plant becomes obsolete may be 30 times what it is today?

More demonstrably, because of the interaction of inflation with our tax system, inflation produces a higher effective tax rate on saving and investment than would otherwise be the case. On the saving side of the ledger, if there is a 4 percent real rate that is taxed and a 4 percent inflation rate, which is also taxed, the effective tax rate on returns to saving will double.

The effect of inflation on the investment side of the ledger is equally clear. Because the U.S. tax code requires firms to carry assets at historical cost, high rates of inflation will erode the nation's capital stock. True replacement costs will exceed the legally allowable limits, and firms will be unable to maintain their capital assets. At the Federal Reserve, we have estimated that knocking four percentage points off the inflation rate is equivalent to a 3.5 percent investment tax credit—not a temporary investment tax credit, not an incremental investment tax credit, but a 3.5 percent *permanent* investment tax credit on all plant and equipment. Such a change would be a substantial stimulus to investment.

In sum, because of the need for long-term planning and to encourage saving and investment, it is clearer today than it was when I went to school that (a) there is probably no long-term tradeoff between inflation and unemployment, and (b) inflation is a lot more costly than we thought it was. As a result, in the United States and around the world, the decision has been made to try to reduce inflation. To say there is no long-run tradeoff, however, does not mean there is no short-run tradeoff. It is well-known that the United States and other countries have experienced slower economic growth in the short-run because of the process of disinflation. The challenge is to lower inflation and accept the short-run costs while adjusting to the new rules governing financial regulation.

Adapting to the Post-Soviet Economic Order

The third international challenge that the United States has faced, unlike the first two, which were intentional, was a surprise: the collapse

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of the Soviet Empire. While clearly beneficial in the long-run—and I point out that the other two challenges will also produce clearly beneficial long-term results—the short-term effect has been to raise real interest rates. I think that this effect is most clearly seen if one examines what happened to Germany. Germany used to be a net capital exporter to the rest of the world. Today, all of that once exported capital is consumed in East Germany, and unified Germany is a net capital importer. On a somewhat smaller scale, the entire former Soviet empire has been turned into a net capital importer from roughly a neutral position. The effect has been to change supply and demand relationships and increase real interest rates here and abroad.

Other Challenges

In addition to the major challenges just discussed, there have been other challenges, such as the Persian Gulf war. If prior to 1990, economic forecasters were asked what a Middle East war with 400,000 U.S. ground troops would do to the U.S. economy, I think they would have said that there would either be a crash landing or no landing at all. In fact, we made it through.

The United States has also been faced with the challenge of ongoing industrial reorganization and the challenge of dealing with the 1990 budget deal. We have juggled all these challenges and have gotten through with, at worst, an average recession.

Some Lessons

We have learned some lessons from the international challenges we have faced: first, the importance of resiliency; and second, the limits of monetary policy.

The Importance of Resiliency

Today the U.S. economy is more resilient, more efficient, than it was in the 1970s. Financial market changes, regulatory changes, a conscious policy of disinflation, and a contractionary fiscal policy have produced a less severe recession than we experienced in the 1970s. The lesson, I believe, is that the proper goal of government policy should be to make markets as resilient and efficient as possible. Government policymakers should get rid of the traditional bottlenecks of overregulation, overtaxation, and overprotection, and let markets work. If we do that, then we can absorb far more severe policy shocks than we otherwise would be able to.

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The Limits of Monetary Policy

There is a second lesson, and I think it can best be summed up as the limits of monetary policy. What is increasingly obvious is that much of the economic dislocation we have is not of a macroeconomic nature but of a microeconomic nature. It is industry specific and regionally specific. For example, as defense spending is reduced, resources need to move to alternative uses, and states such as California will be hit harder than others.

It is obviously impossible for the monetary authorities to run separate monetary policies for California and for the rest of the country. It is also obviously impossible to run separate monetary policies for the defense sector and for the rest of the economy. Given the kind of gross, blunt instrument that monetary policy is, it is therefore often inappropriate.

When we look at statistics that imply a large degree of slack in an economy, we must be conscious of whether those statistics of high unemployment are due to microeconomic bottleneck problems, or whether they are due to macroeconomic aggregate-demand problems. When that distinction is made, I think it should be clear that today our economy is closer to full employment than we might otherwise expect.

Monetary policy is not a solution to microeconomic problems. And one of the greatest challenges we have in the years ahead, in addition to making sure that bottlenecks do not reoccur, is that we do not inadvertently use monetary policy as a tool to cure problems that monetary policy is not designed to cure.

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Rethinking the Framework for Monetary Policy

W. Lee Hoskins

Once again, the Federal Reserve is under attack from lawmakers who propose measures designed to increase the accountability of monetary policymakers while preserving the independence of the institution. Legislation that is currently the subject of debate on Capitol Hill would either remove the voting power of District Reserve Bank presidents (Hamilton 1993; Sarbanes 1993) or require that they be appointed by the President of the United States and confirmed by the Senate (Gonzalez 1993). I will argue in this paper that these efforts (well-intentioned or not) to alter the monetary policymaking process cannot possibly improve the substance of policy, because they do not address the central shortcoming of the present framework: the absence of a single, clear, measurable, and attainable objective for monetary policy. Instead, the political leadership focuses on a mix of objectives that no central bank can provide.

Congress should direct the central bank to promote the maximum attainable level of employment and output by achieving and sustaining a stable price level. The ideal framework for monetary policy includes independence for policymakers in pursuing the objective of price stability and accountability for performance relative to that objective. The Federal Reserve should have complete freedom to design and adopt procedures and set and seek intermediate targets, without political interference. At the same time, it must constantly be held accountable for the results of its actions—for producing a stable price level over time. The appropriate committees of Congress or the Executive Branch must have the authority to, and be specifically directed to,

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remove and replace monetary policymakers if and when the actual price level deviates from stability over a pre-specified time by a pre-specified amount. Meanwhile, policymakers should not be distracted from the objective of price-level stability by congressionally mandated targets for real growth or the unemployment rate.

Some, outside government advocate replacing the Federal Reserve with a private system of money creation, a so-called free-banking environment. I argue that theory and evidence demonstrate the superiority of a government-sponsored central bank or other monetary authority that is guided by a statutory objective of price stability, is independent in pursuing this objective, and is held strictly accountable for delivering it.

The Objective

First, what is the proper objective of monetary policy? A primary goal of public policy is to promote an environment conducive to achieving the highest standard of living that our endowment of real resources and human capital will permit. The pursuit of this goal is necessarily constrained by what is possible and what is not possible.

What Monetary Policy Cannot Accomplish

It is now widely accepted that monetary policy cannot directly deliver permanently higher levels of employment and output. Despite the overwhelming evidence in favor of this proposition, some remain transfixed by the appearance that real economic measures follow movements in money in a predictable way.[1] The body of evidence—from experience, theory, and empirical analysis—against this notion is compelling. Thirty years ago, it was widely believed that monetary policy could raise output and lower unemployment, in exchange for a higher rate of inflation. The rising trends in both inflation and unemployment in the 1970s and the simultaneous disinflation and downward trend in unemployment during the 1980s soundly reject this logic (Council of Economic Advisors 1990).

Yet there remains the apparent lead-lag relationship between money and output and unemployment over the course of the cycle. One possible explanation, from real business cycle theory, is that the public

[1]For example, during recent congressional hearings on monetary policy and the economy, a number of prominent academic economists advocated active manipulation of fiscal and monetary policy to manage the economy. See the testimonies of James Tobin and Robert Solow in U.S. Congress, Joint Economic Committee, "Monetary Policy in 1993," 102nd Congress, 2nd Session, 30 December 1992, and the testimonies of Paul Samuelson and Paul McCracken in U.S. Congress, Joint Economic Committee, "The Economic Outlook," 103rd Congress, 1st Session, February 1993.

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alters nominal money balances in anticipation of future changes in output, creating the illusion that money causes output (King and Plosser 1984). Although this reasoning may not be complete, empirical analysis cannot demonstrate that causality runs in the other direction, from money to output. Granger causality tests are valid only within the context of a given model; if the model is misspecified, the results are worthless. Charles Carlstrom and Edward Gamber (1989) suggest that money causes output in the same way that people carrying umbrellas cause rain. Both assertions arise from models that omit an expectations variable.

Another explanation is that while monetary policy can affect the real economy in the short run, it cannot be actively used to fine-tune business activity. The economy is too complicated and rapidly changing and too little is understood about the monetary transmission mechanism for anyone to confidently and effectively adjust policy to dampen fluctuations. And even if we had sufficient knowledge, even the proponents of fine-tuning acknowledge that only surprise moves in money have real effects, putting policymakers in the position of routinely attempting to deceive the public. Nor can monetary policy favor some sectors, regions, or industries over others, or alter the distribution of income. Historical experience in this country, and around the world, suggests that inflation, as a deliberate policy either to promote economic growth or to affect sectoral or income distribution objectives, produces perverse results and eventually leads to poor economic performance.

What Monetary Policy Can Accomplish

What monetary policy can do to promote maximum sustainable growth is provide a stable purchasing power for the nation's currency, that is, a stable price level. The only policy target over which monetary authorities have complete and lasting control is the monetary base. Through open-market operations, and to a more limited extent by altering the discount rate or reserve requirements, the Federal Reserve can control the monetary base with some precision. Close control of the base gives the Federal Reserve reasonable influence over the broader monetary aggregates from quarter to quarter. Shifts in the narrow monetary aggregates that are unexpected may cause temporary disruptions in economic activity, but in the long-run, determine only the general level of prices.[2] Since monetary policy cannot

[2]Alex Cukierman (1992) notes the transitory effects of money on output. Stanley Fisher (1977) and John Boschen and Leonard Mills (1990) present evidence that money has permanent effects only on the price level.

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be used to advantageously manipulate economic activity, yet cannot escape its role in determining the price level, the natural objective of monetary policy is to provide that pricing environment most conducive to maximum sustained economic growth and the highest possible standard of living. A stable price level is ideal in this respect, where price-level stability is defined as the condition of the general price level that induces individuals to behave as though they expect no change in the domestic purchasing power of the dollar over time. This is popularly known as "zero inflation", but it is more accurately viewed as the absence of change in the average of all prices. Individual prices would move up and down relative to one another in such a way that the average remained essentially unchanged.

The Benefits of Price Stability

The benefits of long-term price stability are numerous and substantial and outweigh the costs of achieving a stable price level. First, price stability is the moral high ground. Congress is given the authority to coin and regulate the value of money by the Constitution. Implicit in this duty is a contract between the central government and its citizens that the purchasing power of a unit of currency will be invariant over time. A policy that erodes the value of money is a breach of this social and moral contract. Second, the existence of a positive rate of inflation induces individuals and businesses to waste scarce resources in efforts to protect themselves, resources which could otherwise be devoted to productive purposes. Third, inflation artificially raises interest rates by the amount of the expected rate of inflation. The uncertainty surrounding future inflation boosts nominal interest rates further, to compensate for the risk that expectations will prove incorrect. As a result, interest rates will be unnecessarily high, even when the average expectation of inflation is correct.

Fourth, price stability is a prerequisite for financial stability. Throughout history, dishonesty, mismanagement, and occasionally stupidity have sparked failures of financial institutions. Instability of the general price level has at times been a greater source of turmoil. By altering expected rates of return on some assets, price-level instability has critically damaged bank asset portfolios with large concentrations in a particular region or industry. The booms in energy prices and agricultural land prices in the 1970s, for instance, were driven by the volatile upward trend in inflation. The unanticipated disinflation in the 1980s sparked the collapse in asset prices that destabilized the financial system (Schwartz 1988).

In addition, general price-level instability has raised the volatility of interest rates and impaired assessment of credit risk and interest-rate

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risk, interfering with intermediation and warping loan decisions. As a main source of financial institution failure, price instability played a key role in weakening the deposit insurance funds. It is well recognized that the variable and rising inflation of the 1970s and early 1980s destroyed much of the capital of the savings and loan industry, encouraging the behavior responsible for the massive obligations of the deposit insurance system that have required tax payer funds. Deposit insurance is badly in need of fundamental reform, but achieving a stable price level would more readily promote stability of the financial sector. Indeed, price-level stability may well be a prerequisite for financial stability (Schwartz 1988).

Fifth, the interaction between inflation and our current tax system, especially as it applies to income generated by capital, represents one of the more significant channels through which non-zero inflation can exact economic costs (Altig and Carlstrom 1990). This source of distortion is often dismissed under the assumption that its effects are minimal or that it could be easily eliminated by indexing the tax system. Correcting the tax code is a good idea, of course, but until that is accomplished, the monetary authorities would be remiss in not doing all within their power to improve social welfare. The horrendous U.S. inflationary experiences of the 1970s and early 1980s induced only limited indexation of the system. Capital gains, corporate depreciation and interest expenses, and personal interest income remain exposed to inflation, and the bracket indexation implemented by recent tax reform does not fully protect taxpayers from "bracket creep" (nonlegislated increases in marginal tax rates created by inflation). Even modest additional steps toward more complete indexation would be difficult to engineer. In fact, the idea of repealing personal income tax indexing is periodically considered.

The argument that these inflation/tax interactions are a significant drag on the economy, but that only Congress should be concerned with the problem, is untenable. The problem exists because of the interactions between inflation and a tax system based in current dollars. Therefore, the responsibility for minimizing these costs lies as much with the monetary authorities as with Congress. It makes more sense for monetary authorities to try to correct the inflation part of the problem, rather than simply hoping that Congress will implement changes that it may be unable or unwilling to pursue.

Finally, an insidious and pervasive group of costs that would be eliminated by a stable price level are those arising from distortion or obfuscation of relative price signals. There is a class of models—the market-clearing, imperfect-information paradigm associated with Robert Lucas and others—in which inflation uncertainty harms the

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economy by distorting the period-to-period relative price signals that facilitate the efficient allocation of scarce resources (Lucas 1972). Despite the pervasive intellectual influence exerted by the Lucas framework to this day, the empirical evidence accumulated since the development of the paradigm in the early 1970s has not been entirely supportive. This point is not lost on critics, who think that the lack of evidence on short-term distortions should persuade us that inflation uncertainty is simply not that important to social welfare. Surely the relative-price/aggregate-price confusion stressed by the Lucas-type models is a special type of uncertainty. The failure to find significant effects arising from uncertainty that is resolved within the frame of a few quarters tells us next to nothing about the type of long-run uncertainty with which the zero-inflation position has always been fundamentally concerned.

Indeed, it seems likely that it is precisely the uncertainty occurring over *extended* time horizons that is most affected by the average inflation rate (Ball and Cecchetti 1990). This is one reason why I favor a price-level target. An inflation-rate target would enable the price level to drift without bound, and with no enforcement mechanism to ensure that inflation mistakes are corrected, the long-run variance of the price level would be infinite. When people have reason to believe that this standard will erode over time, they invest numerous resources to protect themselves. Those who have nominal debt outstanding will drag their feet in paying it back, while creditors will invest in ways to accelerate the collection of funds.[3] The private gains to self-protection are clear, as are the social costs.

Recent experience is the best testimony to the real resource cost of inflation. During the 1970s, people could see that inflation accelerated with each passing year. They guessed, reasonably at the time, that financial assets were of limited value in protecting their wealth from the inflation tax. Consequently, farm land, commercial and residential property, and precious metals became much more expensive as people sought to shelter their wealth. Not only was time spent seeking out these investments, which was socially wasteful, but the resource misallocation itself resulted in a much greater waste of land, labor, and capital that society is still paying for today.

[3]Brazil boasts a state-of-the-art check collection system, with capabilities far beyond what one might expect to find in a developing country. Checks are typically used to pay bills in order to reap the substantial benefits of float during hyper-inflation. In response, banks developed and implemented a check clearing system capable of two-day final collection. Even a check deposited in the headwaters of the Amazon will clear in Sao Paulo within forty-eight hours.

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It is difficult to comprehend how efficient planning within the public and private sectors could be immune to this type of long-run uncertainty. Furthermore, the intuition that long-run inflation uncertainty is costly has some tentative empirical support. Cross-country comparisons have demonstrated a negative correlation between economic growth and the variability of inflation,[4] although Ross Levine and David Renelt (1992) show that the results of these and other studies are highly dependent upon model specification. The case for reducing price-level uncertainty is far more compelling than a cursory analysis might indicate.

Transition Costs and Credibility

Even if price stability is the place to be, some argue, getting there is not worth the ride. Although the transition from some positive rate of inflation to a stable price level may impose costs, the degree to which these costs can be avoided by a credible commitment on the part of the Federal Reserve has been largely overlooked.

In evaluating the costs of attaining zero inflation, economists typically use models in which markets fail to clear, or clear only at some cost. The source of the friction is usually not entirely explicit, but the implication is that we must assume some frictions. It is these frictions, coupled with the inability of markets to clear, that make the costs of ending inflation appear so high.

Yet it only seems logical that these frictions, which make lowering the inflation rate costly, also contribute to making the existence of inflation costly. For instance, a variety of explicit and implicit nominal contracts already exist among people, and a transition to zero inflation could alter the real values of payments from those that were originally intended. But surely the entire institutional apparatus that generates these contracts must involve resource costs that are positively related to the average rate of inflation. One should not compare the costs of getting to zero inflation in non-market-clearing models, where such costs are high, to the benefits of being at zero inflation in frictionless, continuously clearing models, where the benefits are low. If we are going to use a model with frictions to measure the cost of getting to zero inflation, then we should also use such a model to examine the benefits of being there. Such comparisons should be made in the context of present value calculations. These are legitimate grounds for skepticism regarding so many "cost/benefit" estimates of reducing inflation.

[4]For a further discussion of this point, see Roger Kormendi and Philip Meguire (1985); Kevin Grier and Gordon Tullock (1989); David Lebow, John Roberts, and David Stockton (1990).

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Finally, models that do not account for the likelihood that a price-stability objective will be regarded as credible by the public surely overstate transition costs. Economic theory and reasonable model simulations indicate persuasively that, with credible commitment, a central bank can greatly minimize private-sector planning errors during the transition period. I think that much of the disagreement among economists on the size of transition costs revolves around the ability of a central bank to credibly commit itself to achieving its objective. In fact, to the extent that transition costs are related to the divergence between actual and expected inflation, they can be substantially alleviated by credible commitment (Ball 1990, 1991). A simple, but plausible, class of models predicts that disinflation with a credible policy could actually produce a *boom* in economic activity. It still puzzles me that volumes of research have been published on central bank operating procedures and management of monetary aggregates, yet relatively little research has been published on the value of a credible commitment to a price-stability objective. My intuition tells me that the latter is far more important than the former in terms of economic welfare.

Avoiding Multiple Objectives

In addition to being the appropriate objective of monetary policy, price stability must be the overriding objective. Under the Employment Act of 1946, the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978, and the Federal Reserve's own statement of its functions, the objectives of monetary policy are to promote economic growth, high employment, an acceptable balance of trade, stable prices, and an orderly foreign exchange value of the dollar. Politicians appear to expect the central bank to maintain low interest rates as well.[5] Clearly, the existence of multiple targets is a frequent source of conflict. A "perceived" need to "support" the dollar on foreign exchange markets, for example, might dictate greater restraint on bank reserves in order to raise short-term interest rates, which might in turn obstruct goals for employment and economic growth. To be sure, the pursuit by the central bank of high employment and rapid real growth during the last thirty years was instrumental in allowing the price level to more than quadruple along an erratic and unpredictable path. While providing a convenient scapegoat for politicians and protective cover for central bankers, the existence of

[5]When asked his opinion of the Federal Reserve Reform Act of 1991 in a debate among presidential candidates in October 1992, Bill Clinton embraced current policy, because the interest rates that it controls were low.

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multiple objectives that vary in importance over time precludes the intentional achievement of any objective. In particular, price stability and the benefits that accompany it are lost in the process.

To be fair, the economics profession has helped to direct politicians down the road toward multiple objectives. For much of the postwar period, economists advocated active business cycle management, leading the central bank to repeatedly shift attention among objectives. Conventional wisdom today still encourages the central bank to respond to economic weakness, regardless of the underlying cause, suggesting that the lessons of the 1970s are fading from our memories. Calls for lower nominal interest rates or faster money growth to stimulate business activity are apparently based on the notion that a tradeoff exists between inflation and output that can be exploited by the central bank. Even some highly regarded members of the economics profession cling to the notion. At a hearing of the Joint Economic Committee of Congress in late 1992, Paul Samuelson testified that "leaning against the wind" could ensure a closer adherence of actual to potential output (U.S. Congress 1992). Paul McCracken praised the successes of discretionary monetary policy in the 1970s:

> There was great concern that what seemed to be high unemployment at that time was fundamentally structural, that it would not respond to just generally expansive policies. The fact is we [implemented] generally expansive policies, and we got back to full employment. Whenever we have unemployment, one can always look at various things that seem to be a little out of adjustment, out of whack (U.S. Congress 1992).

In reality, as many of us learned, the futile attempts at fine-tuning contributed to higher and less predictable inflation and slower and more variable real growth during the 1970s than during the 1960s.

Ultimately, central bank policymakers, such as the members of the Federal Open Market Committee (FOMC), reflect what is believed by the mainstream. In a 1990 survey of business economists, more than 80 percent of those responding said that reducing the inflation rate to zero over the next five years is *not* the appropriate objective of monetary policy (NABE Policy Survey 1990). Presumably, they believe that the FOMC should be attempting to trade off inflation for economic growth or some other objective. Similarly, the House Subcommittee on Domestic Monetary Policy surveyed, at about the same time, 500 members of the American Economic Association who list monetary economics as either their first or second specialty. The unpublished survey shows that only a slight majority of those who responded favored a monetary policy directed at achieving zero inflation over the next five years.

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These views have had a bearing on policy. Prior to each FOMC meeting, members of the Committee are presented with the views of several prominent economists, which invariably present policy alternatives in the context of a Phillips curve tradeoff. Staff projections at the FOMC meeting also imply such a tradeoff, as do the statements by some FOMC members. Moreover, policy actions, such as a reduction in the federal funds rate, often follow the release of employment or output statistics, further reinforcing the notion that the Federal Reserve can manage real variables. To the extent that this explanation of central bank behavior is valid, inflationary bias will not be eliminated until there is agreement within the profession on price level stability as the dominate objective for central banks.

Fortunately, I believe that day is coming. There is naturally a long lag between the development of theory and its widespread acceptance and application in policy formulation. Policymakers generally draw on theory that they learned twenty or more years earlier. In the postwar period, the focus of monetary authorities has evolved from credit policy, which emphasized interest rates and credit availability, to monetary policy, which emphasized the quantity of money (Friedman 1964). I detect more recently a further evolution toward emphasis on price-level stability. As price-level stability becomes more widely recognized as the optimal objective, I expect it to gain greater favor among policymakers and, eventually, their political watchdogs.

Until that time, as Milton Friedman (1968: 5) has warned,

> We are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making.

Independence and Accountability

Experience in New Zealand, where legislators singled out price-level stability as the primary objective of monetary policy, suggests that it is the mere existence of the objective that is the major force behind containing inflation (Archer 1992). The record in Germany also lends support to this notion. Nonetheless, any gains toward price-level stability may not be sustainable unless the monetary authority is independent to pursue that objective and accountable for achieving it.

Most politicians and many academicians confuse the notions of independence and accountability, and by doing so blur the debate over central bank reform. As typically used, the phrase "independent but accountable" is meant to imply that monetary policymakers should be insulated from political pressures, yet not allowed free reign. In

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the most general sense, however, independence and accountability cannot coexist because one cannot be simultaneously "autonomous" and "answerable." Experience over time and around the world illustrates the importance for central banks of insulation from political pressures.[6] Yet at the same time, there remains the dilemma that no public policymaker—however selected—should enjoy complete autonomy.

The answer is to give central bankers freedom of action (independence) in the pursuit of a single, clear, measurable, and attainable objective, while making them answerable (accountable) for the results of their actions. Independence in pursuing a stated objective—that is, the freedom of action—insulates the institution from political pressures for policies that could impede achievement of the objective. In this context, independence avoids the pitfalls of policy rules that, however flexible and well grounded initially, could become outmoded or under some unforeseen circumstances become destabilizing forces. In contrast, independent policymakers have the freedom to adapt, as markets evolve and our understanding of the economy grows, and implement the most effective methods of achieving the stated objective.

It is widely recognized that politics plays a role in the formulation of monetary policy in the United States.[7] In my view, however, the Federal Reserve has sufficient independence, as established by statute, practice, and a growing body of legal precedent.[8] The Federal Reserve System was created in 1913 in response to banking industry pressure in the wake of a series of panics that seriously disrupted economic activity by contributing to contractions in money and credit. The original charter left many avenues for the Executive Branch to influence monetary policy, some of which were closed when the Banking Act of 1935 removed the Secretary of the Treasury and the Comptroller of the Currency from the Board of Governors. In addition, the law established the Federal Open Market Committee, with the seven Governors and five Federal Reserve Bank Presidents as voting members. This ensured that power within the central bank would be shared

[6]For a further discussion of this point, see King Banaian, Leroy Laney, and Thomas Willet (1983); Robin Bade and Michael Parkin (1987); Alberto Alesina (1988, 1989); Alberto Alesina and Lawrence Summers (1991); Alex Cukierman (1992); Summers and J. Bradford DeLong (1992).

[7]For a further discussion of this point, see Robert Weintraub (1978); Arthur Burns (1979); Nathaniel Beck (1982); Edward Kane (1982); and Richard Wagner (1986).

[8]This is true in general, but it is important to note that much of the Fed's independence arises from the existence and structure of the District Reserve Banks, as opposed to the Board of Governors, which is more directly dependent on the executive branch.

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between political appointees and regional bank presidents, reinforcing the "fire wall" that made the Federal Reserve, and not the Executive Branch, responsible for the conduct of monetary policy.

The independence of the Federal Reserve was strengthened further by the accord of 1951 between the Fed and the Treasury, which established that the Federal Reserve would not be coopted into solving the federal government's debt management problems. Later, the Humphrey-Hawkins Act required the Federal Reserve to set and report on goals for money growth. Nonetheless, the Fed retained great leeway to adjust the targets, redefine monetary aggregates, and alter operating procedures.

During the period since the late 1970s, there have been court challenges to the independence of the Federal Reserve, all dealing with the voting status of District Bank Presidents on the FOMC (Auerbach 1992). Two cases were denied standing. A third was decided in favor of the presidents, and the Supreme Court refused to hear the appeal. This continued the legal precedent established by *McCulloch v. Maryland* that private citizens could direct the monetary affairs of the central bank, in this instance expanded to include serving as voting members of the FOMC.

But freedom to act without undue interference is not enough. Based on meticulous measures of legal independence and deviations of practice from statute, the Federal Reserve has been one of the most autonomous central banks in the world during the postwar period (Cukierman 1992). Even so, the Fed's performance on occasion has been disastrous—witness the one-third contraction in money in the early 1930s and the almost fivefold increase in the price level since 1950, one-third of which occurred in the 1970s. In addition to having independence of action, central bankers must be held accountable for the results of their actions. Ideally, central bank policymakers themselves should be held accountable for achieving the policy objective. The Reserve Bank of New Zealand is a good example. The responsibility for achieving an inflation rate of between zero and 2 percent rests solely with the Governor, who is appointed to a five-year term by the Minister of Finance (Archer 1992). The only other explicit charge is to ensure the soundness of the financial system. If the target is not met, the Governor may be removed by the Minister. Concerns over the personalities or politics of central bank officials and the dangers of discretion in policy formulation melt away under a system that combines accountability for specific results with the independence necessary to achieve them. In such a world, the process used to select individual policymakers is important only with respect to its success in attracting and retaining the most skilled individuals.

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It is unlikely that recent reform initiatives would improve the current process in the United States. The Federal Reserve Accountability Act of 1993, H.R. 28, introduced in the House on January 5, 1993 would require that the presidents of the Reserve Banks be appointed by the President of the United States and confirmed by the Senate. The Act further instructs the President to include among those candidates representatives of agriculture, small business, labor, consumer and community organizations, women, and minorities. In addition, the selection process for the directors of Reserve Banks would be altered. Three Class A Directors would be elected by commercial banks, as under current practice, with the added stipulation that only domestically chartered and owned banks could vote. Six Class B Directors would be appointed by the Board of Governors, up from three currently, again with directions to include minorities and representatives of specific groups (Gonzalez 1993). One aim, presumably is to make the Reserve Bank Presidents the equals of Governors; however, the twelve Presidents would apparently continue to share five votes at FOMC meetings on a rotating basis, although the bill is not clear on this, whereas the seven Governors would retain permanent voting rights. Comparable bills introduced in the House and the Senate on January 26, 1993 would abolish the FOMC, make the Board of Governors solely responsible for the conduct of monetary policy, and establish a Federal Open Market Advisory Council, through which the twelve regional bank presidents could advise the Board of Governors (Hamilton 1993; Sarbanes 1993). All of the bills would mandate greater disclosure of policy deliberations and authorize more comprehensive audits of Federal Reserve activities.

None of the legislation would restrict the independence of policymakers to act, but in the absence of the overriding objective of fostering a high standard of living by maintaining price-level stability, the injection of politics into the selection process would risk compromising policy outcomes. If less emphasis was placed on the skills necessary to stabilize the price level by the President or Congress than by the boards of directors of District Reserve Banks or if the President or Congress actually sought individuals predisposed to pursue objectives other than price-level stability, the substance of policy would suffer. There is every reason to believe this would occur. Senator Sarbanes (D.-Md.) ranks process well ahead of substance:

> It clearly is . . . deficient to have a process which put people in significant policy judgments who are picked by private interests and are making public decisions. Now, they may have made all of the right public decisions, but still, you have to sort of conclude that these people lack the public legitimacy to be making these kinds of decisions (U.S. Congress 1992).

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Senator Sarbanes went on to cite the opposition of President Woodrow Wilson during discussions over the Federal Reserve Act to placing representatives of private banks directly on the Federal Reserve Board. If the private status of policymakers were indeed a valid concern, it would be best addressed by stating the desired outcome of policy and establishing a system of risks and rewards that motivates policymakers to seek that objective. In contrast, focusing on the process is counterproductive when policymakers, regardless of the method of their selection, have the option to choose the wrong objective. This is especially the case when legislators select individuals precisely because they will make that choice.

The argument is not at all transparent, however, that private citizens have no place in the formulation of public policy. In reference to the idea of a National Bank—an early version of a central bank—nearly two hundred years ago, Alexander Hamilton (as cited in Lodge 1904: 29) urged, that

> to attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure, that it shall be under a *private* not a *public* direction—under guidance of *individual interest*, not of *public policy* . . . It would, indeed, be little less than a miracle, should the credit of the bank be at the disposal of the Government, if, in a long series of time, there was not experienced a calamitous abuse of it.

Woodrow Wilson may have objected to, and current lawmakers may shudder at the thought of, private citizens making public policy, but one of the founders of our country saw the virtue in a private sector check on the central government's ability to print money.

Framework for Central Banks

A classic statement of the economic rationale for the existence of central banks was provided by Milton Friedman in his 1959 Millar Lectures at Fordham University, subsequently published as *A Program for Monetary Stability*. Friedman's argument appealed fundamentally to the costs inherent in a pure commodity-standard system (e.g., gold). These costs arise both from pure resource costs and perhaps more significantly from substantial short-run price variability resulting from inertia in the adjustment of commodity-money supply to changes in demand. The inefficiencies represented by these costs are a significant disadvantage of commodity-money exchange systems.

As a consequence there is a natural tendency, borne out by history, for pure commodity standards to be superseded by fiat money. But particular aspects of fiat money systems—such as fraudulent banking practices, "natural" monopoly characteristics, and tendencies for localized

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banking failures to spread to the financial system as a whole—resulted in the active participation of government. We have come to know this active participation as central banking.

These rationales for the existence of central banks have not gone unchallenged, not even by Professor Friedman (Friedman and Schwartz 1986). Disruptions in payments can be costly, but so are the instabilities and inefficiencies caused by the lack of an effective anchor for the price level in fiat money systems. Moreover, theoretical discoveries in the area of finance and monetary economics, closer attention to the lessons of historical banking arrangements, and advances in information and financial technologies have contributed to a healthy skepticism about the superiority of central banks and government regulation to alternative market arrangements. For example, some of the financial backstop functions performed by central banks and banking regulators may have weakened private market incentives to control and protect against risk (Goodhart 1988).

Still, those who argue for alternative monetary structures must at least recognize that their case rests on untested propositions. Yes, it would be wrong to accept unthinkingly our current central banking system as the best alternative for performing the monetary functions of advanced economies, but it would also be wrong to claim that the current central banking system does not reflect society's choice of an institutional arrangement to perform those functions.

It is not sufficient to argue that market-oriented alternatives to our current central-banking systems functioned better in other times and places; for example, in eighteenth-century Scotland (White 1984). This begs the question of why such a system did not prove to be sustainable. Nor is it sufficient to argue that this system would have prevailed if not for government intervention and interference. This line of debate fails to consider whether a political equilibrium exists anywhere that would support a market-oriented system in an advanced economy.

It is premature to claim that some hypothetical monetary system can, or should, come to dominate institutional arrangements that have already evolved from extended political and economic experience. I believe that the prudent first course is to seriously consider the advantages of improving the performance of central banks. The benefits of a properly managed fiat currency are considerable, and the issue is, or should be, how to provide the central bank with a proper charter to insure policy action that generates price-level stability in the long term. There is growing evidence that a political equilibrium exists. The German government long ago directed the Bundesbank to achieve price-level stability above all other objectives. More recently, governments

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in New Zealand, Spain, Canada, and Sweden have some form of price-level stability goal.

The Federal Reserve was born out of a compromise between those who would have kept the banking system entirely private and those who wanted government to assume a prominent role in a rapidly growing economy. Other nations have grappled with the same problems and created similar institutions. Today, many republics of the former Soviet Union and several eastern European nations are facing these same issues. We now have a world monetary system in which governments, through central banks, monopolize the supply and management of inconvertible fiat monies.

The displacement of the commodity standard that prevailed at the time the Federal Reserve was founded has exposed problems not otherwise envisioned in 1913. For example, the price level has no anchor except for that provided by the resolve of Federal Reserve policymakers. Fed policymakers' commitment to price stability is neither as explicit, nor as strong, as necessary for the successful management of a fiat currency. If the benefits of a fiat currency are to be achieved without large offsetting costs, then the gradual demise of our convertible monetary standard has brought us to a point that requires a basic change to the framework within which the Federal Reserve functions.

One proponent of "free banking" acknowledges that monetary reform is not possible without political reform (Wagner 1986). Even should the confluence of events necessary to allow "free banking" occur, in the absence of political reform, it would prove temporary, lasting only until political interests once again diverged.

Conclusion

Scores of new nations are busy constructing central banks to implement monetary policy. Using history as a guide, these new central banks will try to pursue objectives other than price stability, especially since they are being counseled by central bankers with weak records on price stability. Short-term political agendas will likely dominate their policy actions and push them away from the pursuit of price stability. Yet, it seems to me that there are powerful market forces that will crimp the efforts of central banks to mismanage their currencies.

The integration of world markets, particularly financial markets, is limiting the degree to which policymakers are willing to drift away from price stability, at least for the major economies. Twenty years ago the Federal Reserve paid scant attention to the impact of foreign markets on the price of U.S. government securities and interest rates in the United States. Yet, when I participated in the FOMC

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deliberations, we almost always discussed the impact of a policy action on long-term Treasury rates, currency values or the shape of the yield curve. The FOMC now looks at how world financial markets assess the credibility of its policy actions with respect to inflation expectations. This process, in effect, limits the degree to which the FOMC is willing to risk inflationary policy actions.

In Europe, smaller countries often peg their currencies to the German mark, allowing the Bundesbank to determine their monetary policies. The German central bank is also limited by world markets in terms of the inflation path it chooses to pursue. I am not so bold as to argue that markets will cause central banks to wither away to agencies that simply pump out monetary growth rates that provide price stability. However, it does seem to me that market forces are strengthening the hand of central banks in fighting political pressures for short-term "quick fixes" to economic problems. The power of integrated financial markets to focus the world's financial resources on flawed government economic policy was aptly demonstrated in last summer's European monetary crisis. Perhaps even the dullest politicians and central bankers learned the limits of governments in solving economic problems from that experience.

If this view proves incorrect, then central banks will face the prospect of market participants developing private money to a much greater degree than exists today. When government management of particular institutions results in failure, private sector alternatives appear—witness the privatization trend in U.S. schools and courts. Perhaps those who yearn to revisit the Scottish system of free banking may live to see a version of it replace central banking. If so, we are likely to pay a heavy price along the way.

Experience, theory, empirical analysis, and common sense indicate that an unfocused monetary policy or a monetary policy aimed at objectives other than price stability falls woefully short of its potential in delivering the maximum standard of living. Although the optimal system of free banking might yield superior results, I have serious doubts about our willingness to let such a system develop. And why attempt to reinvent what has evolved over time and can be nearly perfected by simple legislation that would explicitly and credibly direct the Federal Reserve to pursue price stability, with independence of action and strict accountability for achieving the objective?

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Which Kind of Monetary Policy, If Any?

Lawrence H. White

Lee Hoskins wants "a single, clear, measurable, and attainable objective for monetary policy." The request sounds reasonable. But notice that no other federal government policy has any such thing. Federal policies in other areas officially aim at multiple, vaguely-defined, immeasurable, or unattainable objectives. Why should we expect monetary policy to be any different? Hoskins notes that economic theory tells us fairly definitely what monetary policy can and cannot achieve. But economic theory also tells us what other government economic policies can and cannot achieve. So why should we expect greater coherence from monetary policy?

My questions are not entirely facetious. When we assign the production of money to government, we should expect inferior money. I see no reason to think that money production differs from mail delivery in this regard. Even if a government agency could be assigned a coherent and desirable quality objective, the problem of accountability or enforcement remains. Particularly with government of the current size and scope, the political process simply does not enable citizen-consumers to hold a government agency tightly accountable for a poor-quality product. Once we take the accountability problem seriously, we should, as Milton Friedman has done (1987: 381), recognize that the best real cure for monetary instability lies in abolishing the Federal Reserve System's money-creating powers. To propose that monetary policy can be harnessed to a single clear and measurable objective is to engage in wishful thinking given the logic of political bureaucracies.

Can a free market provide better money? Following Hoskins' format, I defer this question to the end of my discussion.

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Alternative Objectives for Monetary Policy

Hoskins' assessment of what monetary policy cannot and can accomplish is fundamentally correct. He rightly observes that monetary policy (a) cannot permanently push real output above, or unemployment below, its natural rate, and (b) cannot beneficially stabilize real output through activism. Incentive problems aside, the monetary authority inherently lacks the information it would need to out-forecast and thereby advantageously steer the market.

Monetary policy in a fiat money regime, operating through control of the monetary base, allows the monetary authority to control over time the value of the currency unit, the "nominal scalar" in the economy. The authority can indeed, as Hoskins proposes, produce a flat price-level path over the long term. Alternatively, as Hoskins neglects to consider, the authority can equally well produce a different price-level path, for example a gentle deflation. Or it can produce a desired path for some other nominal variable, for example a flat path in nominal income over the long term. Hoskins unfortunately does not explain why he prefers a flat price-level path to such alternatives.

Hoskins states, "The natural objective of monetary policy is to provide that pricing environment most conducive to maximum sustained economic growth and the highest possible standard of living. A stable price-level is optimal in this respect." Certainly a stable price-level path would be better in either respect (faster growth or a higher standard of living)[1] than the erratic and rising path that has characterized the U.S. dollar consumer price index over the past thirty years. Erratic inflation leads to misallocation of resources in a number of ways (Hayek 1978: chap. 13; Leijonhufvud 1981: chap. 9 and 10). A monetary policy that produced a stable price level would be an improvement. But Hoskins fails to furnish any grounds for claiming that a flat price-level path is "optimal" in any respect. Why does a stable price level enhance economic growth or the standard of living more than a stable volume of nominal income? Why is a stable price level better in either of these respects than a gradually falling price level?

Most fundamentally: what is the microeconomic basis for attributing optimality or first-best status to any particular path for any particular nominal aggregate, once we take into account the interferences with free exchange that are necessary to generate the institutional

[1]Hoskins should have placed "or" rather than "and" between maximum growth and maximum consumption (standard of living). The two are distinct objectives and can conflict, particularly in the choice of a savings rate. Monetary policy may have to recognize a trade-off between them.

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arrangement (government fiat money) that makes such deliberate path-setting possible? In claiming that the "optimal" arrangement is to have a fiat-money-issuing government central bank devoted to a flat price-level path, Hoskins mistakes an improvement for a move to first-best.

Let us put aside for a moment the question of whether any arrangement can be first-best that involves the interventions necessary for government fiat money. Taking a fiat money regime for granted, let us consider the choice among alternative nominal aggregate paths. Friedman (1960) provided the well-known argument that attempting to stabilize the price level directly might in practice destabilize the economy because of the long and variable lag with which monetary policy acts on prices. He accordingly recommended that the central bank produce steady growth in some monetary aggregate, at a rate consistent in the long run with zero inflation, rather than aim directly at a stable price level. Hoskins surprisingly overlooks this argument. In addition, there are affirmative cases to be considered for (a) the objective of stability in some measure of nominal income, and (b) the objective of a declining price level. In the long run, if real income grows fairly steadily, there is little conflict between these last two objectives.

Arguments for stable nominal income (or nominal income per capita, or nominal income per unit of real factor services) have a long pedigree in monetary economics, and have recently been revived by my colleague George Selgin (1990, 1993). Selgin (1990: 266) defends the "productivity norm" of price-level behavior, under which

> the consumer price index is allowed to vary inversely with changes in unit real costs of production. In theory, the productivity norm is equivalent to stabilization of a price index of factors of production; in practice, it is roughly equivalent to the stabilization of per capita nominal income.

The case for the productivity norm is that it better preserves monetary equilibrium than does ordinary price-level stabilization. Stabilizing the consumer price index, after a fall in productivity (for example, due to an oil-price shock) has raised prices, means pushing the price level back down. This action requires a negative monetary shock (contraction of the money stock) that disturbs monetary equilibrium and in the short run intensifies the decline in output brought on by the real shock to productivity. Proponents of the productivity norm see less harm in letting prices rise and remain higher when productivity falls. The reduced standard of living (lower real wage) then arrives through higher consumer goods prices, rather than being forced to arrive through lower nominal wages. Conversely, to push the price level back up after a rise in productivity has reduced prices requires

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the authorities to create a disequilibrating excess supply of money. If the productivity norm is indeed better suited to preserving monetary equilibrium in such cases, it would seem more conducive to keeping the economy near its real-standard-of-living frontier.[2]

An indirect effect of stabilizing nominal income (Py, in the familiar quantity equation $MV = Py$) is a secularly falling path for consumer prices (P) as productivity gains push up real income (y). The merits of deliberately engineering a steady decline in the price level have been intensely debated by monetary theorists over the last twenty-five years. The case for deliberate deflation—at the risk-free real rate of interest, so that the nominal interest rate on risk-free assets would become zero—is that such a policy would allow individuals to hold "the optimum quantity of money" because it would eliminate the opportunity cost of holding currency rather than alternative risk-free financial assets. A competitive real return on currency, generated by deflation, would spare the economy the costs associated with individuals' efforts to economize on currency holdings (Friedman 1969: chap. 1; Woodford 1990). It would eliminate the implicit tax on currency holding, a tax that is inefficient even given a government revenue requirement (Kimbrough 1986).

Hoskins offers six arguments for a flat path in the consumer price level. In doing so he argues effectively for the superiority of a stable price level over the current regime of positive and erratic inflation. But he does not address the question of whether the objective of price-level stabilization should be pursued directly or via a money growth rule, and he argues not at all for the superiority of price-level stabilization over the productivity norm, other variants of nominal income stabilization, or deliberate deflation. My comments on each of the six arguments must be brief and correspondingly blunt.

1. *The U.S. Constitution implicitly gives government a contractual duty to keep the purchasing power of money invariant.* Not so: taken seriously, the Constitution mandates a specie standard. It empowers Congress only to coin money and to specify its metallic content ("regulate the value thereof"). It expressly prohibits the states, and by implication the federal government, from declaring anything but gold or silver a legal tender (Timberlake 1991, 1993). A specie standard delivers greater price-level stability than our current regime, dramatically so over longer horizons, but does not render the purchasing power of money invariant over time.

2. *A positive rate of inflation induces individuals to undertake socially unproductive efforts to avoid losses from holding currency.*

[2]For a fuller discussion see Selgin (1990), and White (1991).

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Yes: but a *fortiori* a negative rate of inflation, driving the risk-free nominal interest rate to zero, is necessary to eliminate such efforts entirely.

3. *Inflation uncertainty boosts the nominal interest rate above the rate necessary to compensate for the (mean) expected rate of inflation, because lenders are averse to the risk of mispredicting the future purchasing power of money, and thus makes real interest rates unnecessarily high.* Hoskins cites no empirical support, but the argument is plausible, given that indexing of financial contracts (which would remove the problem) is costly. It is an argument for low anticipated variance in the price-level path, however, not for a flat rather than rising or falling path. It seems to me that an equally plausible argument could be made, alternatively, for low variance in nominal income, in order to share real-return risk between lender and borrower in the face of productivity shocks. It is not clear that even costlessly indexed contracts would be preferred to fixed nominal contracts in a regime obeying the productivity norm (White 1991: 476).

4. *Price-level stability is a prerequisite for financial stability, for two reasons: (a) Interest rates become more volatile when the price level becomes unanchored.* Yes, because inflation-rate expectations become unanchored and more volatile (Barro 1983). *(b) Instability in the price level causes unexpected changes in relative prices, to the detriment of banks that hold claims to weakening assets.* I would not put the causal process that way. Rather, erratic monetary policy both destabilizes the price level and disturbs relative prices. A significant part of the disturbance to relative prices occurs because of the previously noted excess volatility in interest rates, which causes excess volatility in the prices of long-duration assets relative to other goods and services. All of this is an argument for some nominal anchor, but not for any one particular type of anchor.

5. *Because our tax system is not fully indexed, higher inflation has important distortive effects, especially via taxes on purely nominal capital gains.* Yes; but deflation would reduce the tax burden even further.

6. *Erratic monetary policy distorts or clouds the price system.* Yes; but this again is a case generally for eliminating erratic monetary policy, not particularly for doing so by means of a flat price-level rule. Both the productivity norm and a deliberately deflationary price-level rule, if effectively enforced, would eliminate erratic monetary policy at least as effectively. Either would call for smaller changes in the quantity of base money than a price-level stabilization rule.

My purpose in this section is not to argue for a money-growth rule, for the productivity norm, or for deliberate deflation, as the best

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among fiat money supply policies, all things considered.[3] It is to urge proponents of price-level stabilization to articulate their reasons for preferring their objective to these alternatives. Until they do so, the case for the optimality of price-level stabilization will have the appearance of an empty box.

Hoskins's Defense of Central Banking

It is not surprising that Hoskins is not yet ready to challenge the rationale for central banking. Few former central bankers are (though Paul Volcker [1990], remarkably, has acknowledged that central banking has little or nothing of economic substance to offer to emerging market economies). But I find it puzzling that Hoskins goes out of his way to argue affirmatively for central banking as against free banking.[4] To argue for central banking is surely a diversion from the main point of his paper, which is that a central bank commitment to price-level stability would be better than what we have now.

Hoskins and other advocates of monetary rules should note that idealism in theory—in this context, the preference for a laissez faire monetary system over a government monopoly or legally restricted system—is not the enemy of gradualism in practice—here the preference for fastening a monetary policy rule on the central bank over preserving its discretion. Both Hoskins and the modern free banking advocates want monetary policy rules. Both are on the same side in the battle against the tyranny of the status quo. A free banking rule—which involves abolishing the open market desk—is just a bit more rigorous than the rule Hoskins favors.

It is therefore puzzling that Hoskins makes sweepingly conservative arguments, favoring the status quo, against the free banking case. When he demands that "those who argue for alternative monetary structures must at least recognize that their case rests on untested propositions," he should recognize that such a demand equally applies to his own case for monetary reform. Those who argue for free banking have at least attempted to "test" their propositions by examining the

[3]The productivity norm was originally developed as a case for not altering the metallic content of a specie standard, against the case (mostly made during periods of falling prices) that alteration in the standard was desirable for the sake of price-level stabilization. Free banking on a specie standard can be thought to approximate the norm automatically (Selgin 1988: 98-103). It is another question whether the monetary authority in a fiat money regime should be directed, or could manage, to obey the norm through deliberate policy, considering the accountability problem and the practical problems of implementation.

[4]In his closing paragraph Hoskins takes a different tack, allowing that "the optimal system of 'free-banking' might yield superior results," but suggesting that the transition to free banking poses major problems.

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historical evidence on relatively unregulated monetary systems (see Dowd 1992). Hoskins' arguments for a price-level rule remain untested, in his paper at least, against any evidence from New Zealand or wherever else a single, clear, and measurable price-level objective has been legislated.[5]

Hoskins's substantive argument against free banking contains nothing really new. He draws it almost entirely from Milton Friedman's earlier (1960) case for government intervention in money. Friedman cited the resource costs of a 100 percent commodity reserve system as a rationale for the emergence of redeemable fiduciary money (not "fiat money," as Hoskins has it). It is true that such costs—as faced by bank depositors—naturally lead the market to fractional reserve banking. It is not true that the remaining resource costs represent a source of inefficiency, if money-users voluntarily incur those costs in order to gain the benefits of a commodity-redeemable money (Garrison 1985).

It is not even true that the resource costs (the sacrifice of alternative uses of gold and gold-producing inputs) are lower under a pure fiat system, unless the rightful holders of gold coin and bullion stocks voluntarily melt them down for commodity use. Private gold coin and bullion stocks around the world have not been melted down yet; not even central banks, with one or two desperate exceptions, have sold their stocks. The real price of gold is actually higher now than it was under Bretton Woods or the classical gold standard, suggesting that even greater resources are being devoted to the mining, minting, and hoarding of gold coins and bullion. *Perhaps* gold coins and bullion would be voluntarily melted down upon the enactment of a Hoskins-type price-level rule. But Hoskins must at least recognize that in this respect his own case rests on an untested proposition.

I am surprised that Hoskins criticizes the classical gold standard's price-level performance. It seems to me that he should find it rather attractive by comparison to the performance of post-gold fiat money standards.

Hoskins goes on to cite Friedman's (1960) rationale for government monopoly in the provision of fiduciary money, namely, the fears that competitive private note-issue is inherently prone to fraud and to overissue. Neither fear is historically or theoretically well grounded, as Friedman and Schwartz (1986) have more recently recognized, in

[5]It might be said that those who argue for the status quo should recognize that their case rests partly on untested (by them) propositions about the consequences of a switch to an alternative regime, and partly on falsified propositions about the properties of a discretionary fiat regime.

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light of the historical and theoretical research that monetary economists have done since 1960. Hoskins asks why free banking in Scotland did not survive to the present day. In brief, it fell victim to a combination of rent-seeking by established bankers and dubious theoretical arguments by monetary economists (White 1984: 76-80).

Hoskins makes the novel claim that a "political equilibrium" exists to support a price-level stability rule. His evidence is frustratingly thin. He claims that Germany, New Zealand, Spain, Canada, and Sweden "have some form of price-level stability goal," but makes no reference to sources of information about the nature of the commitment to price stability in these countries, or its results. New Zealand does have legislation, only a few years old, that directs the central bank to aim for inflation in the 0-2 percent range. We have not yet seen how effective the legislation will be in actually stabilizing the price level. More germane to the claim of "political equilibrium," we have not yet seen how long it will stand up against future demands that Parliament give the central bank a more ambitious agenda. I am not aware of any similarly unambiguous commitments in the other countries.

For what it is worth, I am probably no more optimistic than Hoskins about the likelihood that the U.S. Congress will vote to allow a free banking regime in my lifetime. I share Hoskins's "serious doubts about our [government's] willingness to let such a system develop." I agree that a premature legislative victory—achieved by some unlikely accident—would probably be reversed. But any monetary reform, including a legislated price-level stabilization rule, is subject to exactly the same frailty.

The switch to an alternative monetary regime could be embodied in a constitutional amendment to enhance its durability. A free-banking amendment, which would simply enumerate what the federal government may not do (manipulate the quantity of money or restrict the freedom of contract with respect to money), would be easier to write down and simpler to enforce than a Hoskins- type price-level-stabilization amendment, which would leave independence for monetary policymakers in pursuing a given objective, but hold them "strictly accountable for delivering it." To provide strict accountability, the amendment would have to specify exactly what objective the monetary officials are required to pursue (what measure of stability, over what time horizon, with respect to what index of prices, with what provisions for revising the index) and how they are to be held accountable for their performance (what penalties are to be imposed, on whom, when, for failures of various magnitudes).[6]

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Conclusion

Incremental improvements are certainly worth thinking about. Among nominal-path goals that leave the central bank and fiat money intact, more work needs to be done to sort out which goal, all things considered, is most desirable: a flat path for a consumer price level, a declining path for a consumer price level, a flat path for a producer price level, a flat path for nominal income, or possibly something else. We should not let the good be the enemy of the best in monetary reform. Milton Friedman (1987: 368-69), long the best-known advocate of a monetary rule, has rightly noted that any rule that leaves the monetary policy bureaucracy intact carries the seeds of its own undoing, especially a rule in the weak form of a resolution or legislation that the Congress is left to enforce. A central bank will tirelessly resist being held accountable for its monetary policy choices. If the "political equilibrium" exists for a stronger reform, on the order of a constitutional amendment, there is no reason not to press for a first-best change in regime.

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[6]J. Huston McCulloch (1991) has taken a different approach, writing out an explicit error-correction rule for the money stock designed to be consistent with long-run price stability. Implementing McCulloch's approach involves specifying exactly what day-to-day actions the monetary authority is to undertake, based on previous specifications of (a) the measure of the money stock it is to adjust, (b) how quickly, (c) the particular error-correction formula it is to use, and (d) the particular price index, and its target level, to which the formula is to be applied.

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Banking and Government: An Unholy Alliance

Judy Shelton

In the back of my mind, I keep hearing the strains of the song from the film *Cabaret:* "Money makes the world go around, the world go around . . ." Indeed, money is the driving force behind the global economy. My goal here is to focus on the extent to which the regulatory environment affects how banks make the money go around.

That *is* what banks are supposed to do, is it not? Interestingly, at the more abstract levels of finance theory it is difficult to justify the existence of financial intermediaries because if everyone had perfect information (and the existence of perfect information is a typical assumption in theoretic formulations), there would be no reason to pay banks to act as middlemen for channeling financial capital to productive investment projects. Individuals would just do it directly for themselves.

In the real world, though, what banks are presumably selling to depositors *is* their expertise in evaluating investment opportunities. For that, bankers take a cut of the return from their loan portfolios and pass on some lesser rate of return to the depositors.

Distorting Impact of Government-Imposed Standards

Now into this fairly straightforward relationship among depositors and borrowers, with bankers in the middle bringing the parties together and channeling the money into those projects that offer maximum return with minimum risk, we introduce a hugely distorting factor—federal deposit insurance.

The unholy alliance that exists between government and the banking industry is well-known. Bill Niskanen and other contributors to this

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volume allude to it. The alliance boils down to this: The presence of government-provided deposit insurance opens the door for government surveillance and regulation of banking operations and management. Such a Faustian arrangement engenders tremendous conflicts of interest and invites governmental abuse of power. Imposition of the Basle International Capital Adequacy Standards will only serve to strengthen efforts to institutionalize this compromised relationship at the global level.

The strongest argument put forward in favor of the BIS capital standards is encapsulated in the weighty word: "prudence." It is difficult to be against prudence in banking. Therefore, when government monetary and banking authorities from the world's most powerful nations join together in asserting that these rules will make private bankers behave more prudently, and that these rules will harmonize the supervision of banking on a global scale, citizens should presumably feel much relieved.

However, when it comes to maintaining the viability and soundness of banking—or any business—I personally have more faith in the aggregate impact of the profit motive. Generally, in order to make profits, one has to stay in business. It is the mammoth role of the government in the banking industry that distorts what would normally be a sufficiently reliable incentive to exercise prudence voluntarily. Evidence is already accumulating to support the concern we should have had from the outset that the standards would have perverse effects. The Basle Accord steers commercial banks toward government lending rather than making loans to private business. Indeed, there is a capital penalty associated with making loans to business. That is not merely a perverse effect, it is a violation of the raison d'etre of banking. A U.S. Treasury bond is considered the "riskless asset." Why do depositors need the special expertise that banks offer in evaluating risky investments if their savings are going into Treasury obligations?

Speaking of riskless assets, or government-issued bonds, the BIS capital standards with their various risk-weighted classes do not differentiate among borrowers within a given risk class. So a bank can escape the capital penalty by making "sovereign" loans to governments—which are zero risk-weighted—without having to take into consideration whether those loans are to the U.S. Treasury or to an obscure newly-formed country. The same illogic is applicable under the BIS standards to private business loans, where a bank is penalized with the 100 percent risk weight requiring the full 8 percent capital backing: It does not matter whether the loan goes to a top-rated corporate borrower or to a venture capital start-up company. A banker who finds himself operating in a framework of rules that are set up

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to ensure that there are minimum costs, in terms of required capital backing associated with lending to government (any government), and maximum revenues associated with lending to the riskiest business clients, seems to have no choice but to embrace the regulatory authority's definition of banking prudence and discard his own.

Therein lies a grievous problem with the Basle capital adequacy standards: They elevate form over substance. They cause bankers to satisfy superficial rules rather than fulfill underlying objectives. Such artifice fosters a certain cynicism in the business. The financial industry is nothing if not innovative when it comes to getting around regulations. Playing a game that requires continuous mutation, banking institutions invent new forms of instruments (derivatives, options, swaps) providing a constant stream of tailor-made financial devices for coping with changing economic and regulatory circumstances. The sad irony is that government-imposed standards cause bankers to focus on the letter of the law even when it works against the intent—which is, presumably, to manage bank assets and bank liabilities responsibly.

Money and Banking: Conflict of Interest

There is something even more disturbing about global regulatory supervision over banking. It goes back to the question of conflict of interest and the potential for governmental abuse of power.

The BIS standards permit governments to tighten their hold over the banking industry. They enable governments to borrow money to finance their excess spending by coercing banks to use depositors' money to buy government bonds: clearly, a conflict of interest. Consider, too, that governments exert control over the money supply and currency values domestically and abroad through their central banking systems—again, a conflict of interest. No central bank is truly independent of government. Even the Bundesbank caves in when political pressures become sufficiently intense.

Projecting forward, we seem to be moving toward a world where the function of banks is to operate a network of collection sites for the government. The savings of the people are received by banks and passed through to the government where they go directly into the budget to pay for domestic spending, a process very much in keeping with Lenin's vision of banking; that is, a nationalized collection system with branches in every rural town through which the savings of the peasants automatically become the working capital of the government. That is the way the Soviet banking system worked, in fact. Or did not work.

A similar process is beginning to characterize a large segment of the banking industry in Japan. In the last two years, Japan's small

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depositors, mostly housewives charged with managing the family savings, have been quietly taking their money out of commercial banks and moving it to postal savings accounts. Japan's postal system, which is overseen by the Ministry of Post and Telecommunications, now holds 30 percent of Japanese individuals' deposits, equal to about $1.4 trillion dollars, easily making the Japanese postal system the world's largest financial institution. Deposit growth at Japan's commercial banks has slowed by half since spring 1991, while money has flowed into postal savings accounts. These accounts—which are called *teigaku* accounts—pay higher interest than bank time deposits, savers can withdraw money freely after six months without giving up any interest, and with 23,000 branches (there are post offices in the most remote corners of the country), they are quite convenient. The postal savings system is not a member of the Deposit Insurance Corporation and pays no taxes or shareholder dividends. As its officials like to point out: "The Ministry of Post and Telecommunications will not go bankrupt." Why should Japanese savers *not* take their money to the post office—which then recycles it to the government—if commercial banks are doing essentially the same thing by making government loans, and at the same time extracting a larger cut from the depositors for it?

The point is this: Excessive regulation at the national and now the international level is transforming banking into less a private business activity and more a mechanism for funding the growth of government.

The Tyranny of "Peer Pressure"

My final observation concerns the perceived power of enforcement behind the Basle Accords. Officially, compliance with the accords is expected to be achieved through peer pressure. What exactly does that mean? Vagueness about enforcement is a classic bureaucratic tool for keeping those affected off-balance. When one does not know whether or not actions are punishable, or what penalities will be imposed, one is more tempted to circumvent the rules.

Enforcement of a very subtle nature is likely to be exercised by the Group of Seven (G-7). Just as central banks often end up accommodating the fiscal mismanagement of their governments, the Bank for International Settlements—the central banks' central bank—is likely to end up serving the interests of the Group of Seven.

Lately, the G-7 has engaged in acts of political and financial arm-twisting rather than friendly coordination. From Japan's perspective, it must seem as if the Group of Seven has transmogrified into the "Gang of Six"—all aligned against Japan and demanding that the

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Japanese government step up domestic spending to stimulate its economy. Why? Because Japan is seen as the only G-7 country that can afford to spur world growth while the United States and others are limited by budget deficits caused by excessive spending. Such a rationale is reminiscent of the earlier doctrine: From each according to his abilities, to each according to his needs.

The G-7 has no real enforcement mechanism it can utilize, unless one considers that certain off-the-cuff remarks might constitute a show of power or a shot across the bow. Treasury Secretary Lloyd Bentsen has publicly noted that he is not necessarily in favor of a weak dollar. But he would like to see a stronger yen. According to accounts in the financial press, top Japanese officials found that particular remark by Secretary Bentsen "annoying." But as the Gang of Six is quick to suggest, a strong yen is actually good for Japan because it reduces the value of its foreign loans and that helps Japanese banks meet the BIS capital requirements. Plus, since a strong yen causes Japanese exports to be more expensive, fewer American and European consumers will buy them, and that will help defuse pressures on the Gang of Six to impose protectionist measures against Japan. How comforting, how reassuring.

In closing, I would like to make reference to the problem of "moral hazard" which is so often invoked when discussing the banking industry. In my opinion, the greatest moral hazard threat to global financial stability stems not from the profit-driven motivations of bankers, but from the increasing ability of government to divert financial capital away from private business and into their own coffers. Imposing new global regulatory standards, which serve to strengthen the hold of government over the banking industry, gives increased momentum to that dangerous trend.

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The Evolving Legal Framework for Financial Services

Walker F. Todd

This paper summarizes both the history of financial services regulation in the United States and the conflicting models of political economy, or the legal framework, that lay behind that history. The principal supervisory intervention and closure options available to financial services regulators by the late 1980s are described briefly. Many of those options were modified or even extended by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[1] but numerous older supervisory tools that had fallen into disuse after the advent of federal deposit insurance and direct federal intervention in the capital markets affecting financial services institutions during the 1930s remain neglected.

The primary purpose of this paper is to review the legal framework for the supervision and regulation of financial services both as it has been and as it might be. Specific policy recommendations regarding expansion of the activities of one set of financial institutions across industrial sector lines into the domains of other financial institutions, or innovations in financial services supervision, are beyond the scope of this paper.

A Brief History of Financial Services Regulation in the United States

It is a common misconception that banks and trust companies, bank holding companies, thrift institutions, credit unions, securities firms,

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The author is Assistant General Counsel and Research Officer at the Federal Reserve Bank of Cleveland. The views presented in this paper are entirely those of the author and do not necessarily reflect the official views of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System. Earlier drafts of this paper benefited from comments by James B. Thomson and from extensive contributions by Andrew W. Watts in the sections dealing with regulatory intervention and closure options. Tess Ferg provided the principal and final edits.

[1]FDICIA, enacted December 19, 1991, is Public Law No. 102–242.

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insurance companies, mutual funds, and the like, all of which are usually referred to as financial services companies, have existed in more or less their present form throughout U.S. history or, even earlier, in British history.[2] But the present common legal form of large banking organizations in the United States, a bank holding company with many banking and nonbanking subsidiary corporations, was rare in the 19th century and became the generally accepted model only after World War II. The most frequently advocated alternative model for large banks, a universal bank with branches nationwide, has never existed in the United States, and the closest approximations, the First and Second Banks of the United States, were so limited in their asset powers that they could not properly be called universal banks.[3] Even in Great Britain, the model of the universal bank with nationwide branches has come into existence only since enactment of the Financial Services Act of 1986.[4]

Prior to enactment of the National Bank Act (1863), most American banks did not have corporate charters, and even those that did still exposed their shareholders to double liability. Shareholders were liable to the bank regulator for assessments up to the par value of their shares, then a substantial amount, if the bank's assets were insufficient to satisfy liability holders' claims. Thus, there was a fair amount of personal liability on the part of directors and ordinary shareholders if their institutions failed. Also, before the National Bank Act, most bank charters were issued only for limited terms—20 years was the most common.

Perpetually chartered, limited-liability, incorporated banks having as their principal liabilities deposit accounts instead of circulating notes were a novelty of the second half of the 19th century in the

[2]Other nations' histories either are or have been somewhat relevant to (and are often cited as possible models for) the restructuring of American legal and financial services institutions. Although those histories are interesting and often instructive, the hard fact remains that, as a matter of legal history, only the English and Scottish experiences are directly relevant to the actual evolution of the framework for the American financial services industry. The future, of course, might be different, but the past is less mutable on this point than proponents of universal banking or expanded governmental subsidies of the financial services industry might wish to acknowledge. For detailed analysis of this issue, see Mark Roe (1993).

[3]Useful summary descriptions of the legal structures of the First and Second Banks of the United States appear in Judge Harold Greene's supplemental opinion in Melcher v. Federal Open Market Committee, 644 F.Supp. 510 (District Court D.C. 1986). Subsequently, Melcher was affirmed on other grounds, 836 F.2d 561 (D.C. Cir. 1987); certiorari denied, 486 U.S. 1042 (1988).

[4]Good descriptions of the legal forms and structural organizations found among large banks in early American history appear in Bray Hammond (1957) and J.S. Gibbons (1859). A comparable description for Britain, especially for Scotland, is in Lawrence White (1984: 23–49).

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United States. The National Bank Act authorized "national associations" to obtain federal banking licenses in order to enable partnership and sole-proprietorship banks to join the bond-secured currency scheme, and state law also licensed banks but did not require them to incorporate.

Neither the Federal Reserve Act (1913) nor the Banking Acts of 1933 and 1935 required member banks to incorporate, and the double liability of national banks' shareholders was not eliminated until the Banking Act of 1935. Instead, the impetus for incorporation was provided by the Emergency Banking Act of 1933, which authorized the Reconstruction Finance Corporation (RFC) to assist the reorganization of troubled banks by purchasing their preferred shares (it was easier to obtain the RFC's assistance for incorporated banks). Private banks holding commercial bank or trust company licenses still exist under New York state law: Brown Brothers Harriman is one example, and even J.P. Morgan & Co. did not incorporate until 1940 and did not become a widely held, publicly traded corporation until the 1950s.

Investment companies, securities broker-dealers, investment banks, mutual funds, mutual thrift institutions, mutual insurance companies, and the like are not required to incorporate as a matter of law. It is possible to derive from this description of the prior legal framework the hypothesis that it was the personal liability of the principals of unincorporated financial services institutions that used to encourage the prudent operation of their firms, and that it was governmental incentives like the prospect of RFC assistance that tempted those principals to incorporate (see analogous arguments in Edward Kane (1987: 104–05), and Adam Smith (1976, book II: 329–37).

More than just banks alone, financial services corporations were generally considered to create moral and legal difficulties that ordinary business corporations did not because, before the Free Banking Era (1838–61), they depended on the favor of the state for their corporate charters and continued profitability. Adam Smith wrote disparagingly of the joint-stock trading companies of his day; the framers of the Constitution noted the American prejudices against corporations of any type, but especially against "monied corporations," and deliberately failed to include an incorporations clause in the Constitution; Andrew Jackson opposed banks primarily because they promoted the circulation of paper money; late 19th and early 20th century political rhetoric denounced the "money trust"; New York attorney Charles Evans Hughes became famous as legislative counsel investigating the misdeeds of insurance companies in 1905; and as late as 1913–14, Louis Brandeis wrote a series of articles (later compiled into a book) on the economic inefficiencies of large holding companies of the

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J.P. Morgan model, entitled *Other People's Money and How the Bankers Use It.*[5] Both Hughes and Brandeis later became justices of the U.S. Supreme Court.

Abundant arguments existed on the other side, to be sure: Alexander Hamilton succeeded in obtaining a federal corporate charter for the First Bank of the United States; Chief Justice John Marshall sustained the constitutionality of the federal corporate charter of the Second Bank of the United States in *McCulloch v. Maryland* (4 Wheaton [17 U.S.] 316 [1819]); a whole system of federally chartered national banking associations was established under the National Bank Act; and incorporated Federal Reserve Banks were established nationwide under the Federal Reserve Act of 1913.[6] Financial services companies could and did exist in corporate form and even with federal charters, but the older, Jeffersonian, Madisonian, and Jacksonian notions of minimal federal interference in state regulation of financial services have prevailed to the extent that the chartering, licensing, and most forms of supervision of nonbank financial firms remain the exclusive domain of state law.[7]

Reforms of the 1930s changed the legal framework for financial services significantly, but banks and, later, bank holding companies were more directly affected by federal centralization and regulation than were nonbank financial firms. For the most part, the latter were allowed to continue operating under state law, becoming subject only to federal registration and information disclosure laws in the 1930s and federal consumer protection legislation in the 1960s and 1970s. Federal deposit insurance was created in 1933 and was made available to state-chartered, nonmember banks as well as to Federal Reserve member banks, then considered a political triumph for proponents of state banking. A serious attempt was made to nationalize all bank supervision as part of the Emergency Banking Act of 1933 (Wyatt 1933), but that effort was abandoned in favor of the de facto nationalization of both financial and nonfinancial firms' capital structures between 1932 and 1947 under the Reconstruction Finance Corporation Act (see Todd 1992). Bank branching activities, which became restricted in the early 1900s, were liberalized in 1927 but retrenched somewhat in 1933, and branch banking did not expand significantly again until the 1960s. Bank holding company expansion became a

[5]See A. Smith (1976, book V, chapter 1: 245–82); Tansill (1965: 563, 724–25); Schlesinger (1945: 76–77); Mowry (1958: 79); and Brandeis (1914: 135–223).

[6]See Hamilton (1790, 1791); Hart (1899: 230–52, 274–88); and Smith and Beasley (1972: 90–94).

[7]See Jefferson (1791); Madison (1791); James (1938: 556–58); and Schlesinger (1945: 76–77).

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device for evading restrictive branch banking laws in the 1920s, but was retrenched between the 1930s and the early postwar years. The Bank Holding Company Act of 1956, its 1966 and 1970 amendments, and the International Banking Act of 1978 (for foreign banks) imposed federal restrictions on bank holding company and foreign bank expansion that have made the creation of nationwide branch or subsidiary banking networks legally and practically impossible, although the advent of automated teller machines has tended to undermine these restrictions.

On the whole, prior to the 1980s, the legal framework for financial services regulation in the United States was constructed roughly as follows:

1. Banks and bank holding companies were regulated primarily at the federal level, but limited chartering and supervisory responsibilities were retained at the state level.

2. After the 1960s, a gradual trend emerged pursuant to which investment banks, securities broker–dealers, and mutual thrift institutions converted to corporate form. The securities firms retained their general independence from federal regulation other than the registration and disclosure type of requirements.

3. Since the 1970s, it has generally been presumed in banking reform circles that financial services companies should be allowed to engage in all activities not specifically prohibited. Efforts to have federal bank regulators expand the range of permissible activities by administrative interpretation have tended to reflect that presumption. But the long-standing prior view under American and British law was that only activities specifically authorized or "so closely related to banking or managing or controlling banks as to be a proper incident thereto" should be permitted for member banks and bank holding companies.[8] In other words, the governing assumptions regarding the appropriate boundaries of the legal framework for financial services have changed within the last 20 years or so, but the reasons for that change remain somewhat unclear. In any case, the implementation of the altered assumptions through administrative decisions has had uneven success in the courts.[9]

[8]This phraseology appears in Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. Section 1843).

[9]See, for example, Board of Governors v. Dimension Financial Corporation, 474 U.S. 361 (1986), in which the Supreme Court decided, 8–0, that the Board lacked the authority to reinterpret the statutory definitions of terms like "bank" or "commercial loan" in Section 2(c) of the Bank Holding Company Act (12 U.S.C. Section 1841) so as to extend the Board's regulatory authority to nonbank banks. Such banks generally remain outside Federal Reserve regulation unless they are owned or controlled by banks or bank holding companies. On

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4. Some authorities maintain that there is a type of "natural market segmentation" or compartmentalization in the financial services industry, to which a legal structure eventually returns, with commercial banks specializing in short-term loans to fund industrial, agricultural, and retail enterprises; thrift institutions specializing in home mortgage finance; insurance companies sticking closely to core insurance and annuity activities; and securities firms and investment banks financing the medium- and longer-term credit requirements of commercial and industrial enterprises. Such segmented or compartmentalized systems have appeared, in fact, in America periodically from the time of Alexander Hamilton to the present moment, but most modern proponents of banking reform in academic circles have advocated reduction or elimination of geographic and activities restrictions on financial services companies.[10] Intra-industry and intra-regional consolidation tends to reduce the competition that is presumed in a free market, but the modern proponents of banking reform apparently prefer to have different industry sectors compete against each other to restore competitive balance. It is unclear how well grounded in historical analysis the current reform proposals are, but advocates of sectoral segmentation and compartmentalization usually base their arguments on historical analyses that, of course, the opponents contest.[11]

Conflicting Models of Political Economy

Before drawing hard and fast conclusions about the appropriateness of different approaches to financial services reform, it is useful to review the principal attributes of the competing models of political economy that might be relevant. In the United States, socialist models have been disfavored, but strong centrally planned models like corporatism occasionally have been accepted in governing circles, during the First New Deal, for example (Phillips 1992). Classical liberal or negative liberty models have as their principal attributes preferences

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the other hand, most of the Board's orders liberalizing securities powers of the affiliates of member banks, reversing prior, limited interpretations of Section 20 of the Banking Act of 1933 (12 U.S.C. Section 377), have withstood court challenges since the early 1980s.

[10]The idea of "natural market segmentation" is discussed favorably by, among others, John Austin Stevens (1898: 264), and, nearly 100 years later, Hyman Minsky (1993), who in turn credits Jan Kregel (1992) for this idea. On the other hand, the idea of dismantling segmented or compartmentalized financial services institutions is discussed favorably by, among others, Catherine England (1993), George Kaufman (1993), and U.S. Treasury (1991).

[11]The best-known historical analyses in favor of segmentation and compartmentalization of financial services are Louis Brandeis (1914) and Ferdinand Pecora (1939). Among the better-known recent critiques of those analyses are Eugene White (1986) and George Benston (1990). For a good current restatement of the recent critiques, see David Wheelock (1993).

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for the operation of free markets under the Rule of Law (see Hayek 1944). Such free markets are usually characterized by the absence of protectionism (no artificial barriers to market entry) and the absence of subsidy, which might be negative (as with supervisory forbearance, for example; see Woodward 1992). But utilitarian or positive liberty models, with attributes preferring limited governmental intervention or regulation in the operations of markets to correct for perceived "market failures," have adherents whose views might be described as the dominant world view in Washington since the 1930s. One way of explaining the 1930s' financial services reforms is as the product of a struggle between Brandeis antitrust liberals (utilitarians) and central planners of the left corporatist type, e.g., Rexford G. Tugwell and, perhaps, Adolf A. Berle (see Phillips 1992: 62–67; and Olson 1988: 111–14).

In general, it was the classical liberals who lost out in those 1930s' policy debates.[12] Thus, classical liberals need to think carefully before defending 1930s' policy reforms. Similarly, those whose reference points are earlier, the era of Alexander Hamilton and Thomas Jefferson, for example, should bear in mind comparable distinctions as to appropriate models. Hamilton was essentially a positive liberty thinker, while Jefferson's and, to a slightly lesser degree, Madison's ideas reflect negative liberty values. Utilitarian and corporatist methods often are inconsistent with classical liberal models—a principle that should be remembered as we evaluate the supervisory and regulatory structures described below.

Regulatory Intervention and Closure Options in the 1980s

Banks, bank holding companies, and thrift institutions were subject to the supervisory and regulatory intervention and closure procedures described below during the 1980s. Some of these procedures evolved from specific supervisory experiences during the 1960s and 1970s, such as limitations on standby letters of credit (1974), but most were derived from statutory changes in the 1930s or even from long-standing banking customs. Not until enactment of the Competitive Equality Banking Act of 1987 (CEBA) for the thrift industry and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) for federally insured institutions generally was there a statutory shift away from the long-term trend toward relaxation of

[12]Herbert Hoover and Carter Glass were, I suppose, the leading illustrations of this proposition. See generally Hoover (1952) and Rixey Smith and Norman Beasley (1972).

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examination and capital ratio standards, the low point of which was the Garn–St Germain Act of 1982. Garn–St Germain was perceived as having created perverse incentives for insured institutions, and CEBA and FIRREA generally were viewed as attempts to rein in some of the excesses attributed to those incentives (see generally Kane 1989, and Mayer 1992). Basically, FIRREA was an attempt to reintegrate the legal and economic rationales for supervisory intervention, and FDICIA has carried that attempt somewhat further.

Most of the enforcement tools needed by supervisors and regulators already existed before FDICIA was enacted in 1991. The federal bank supervisory and regulatory agencies' powers to intervene in the affairs of banks and bank holding companies ordinarily were limited to such institutions in troubled or failing condition prior to enactment of FDICIA. Apart from filing periodic call reports or submitting to supervisory examinations or inspections, most banks and bank holding companies had, and after FDICIA still have, uncontentious relationships with their supervisors and regulators. Most banks are not required to restructure their liabilities in ways that affect the legal rights or financial returns of depositors and other claimants. This part of the paper ignores issues regarding the supervision and regulation of institutions that would be classified as adequately or well capitalized under FDICIA's standards and focuses instead on the supervisory regime for troubled and failing institutions before FDICIA. The next part of the paper focuses on changes to that regime made by FDICIA.

Enforcement Actions

The three principal federal bank supervisory and regulatory agencies (hereafter referred to simply as the Agencies) long have had at their disposal a variety of instruments to redirect a bank's affairs. Possibly the most significant is the cease-and-desist order.[13] Section 8(b) of the FDI Act authorizes the Agencies to issue such orders against insured banks and institution-affiliated parties. Before initiating the action, however, an Agency must find that an unsafe or unsound practice has occurred, is occurring, or is about to occur, or that a violation of law, regulation, written agreement, or other written condition imposed by the Agency has occurred, is occurring, or is about to occur. After making the required findings, an Agency must satisfy

[13]Other similar enforcement actions employed by the Agencies are the written agreement and the memorandum of understanding. Like the cease-and-desist order, the written agreement is a formal supervisory action. The memorandum of understanding, however, is informal. The Agencies, with respect to commercial banks, are the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC.

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several procedural requirements, including giving notice to the named parties and providing the opportunity for a hearing, before it may issue an order. Once such an order becomes final, it is enforceable by the courts (see 12 U.S.C. Section 1818[i][1]). Violations of a cease-and-desist order may also result in the imposition of civil money penalties by the Agencies, which may reach $1 million per day (12 U.S.C. Section 1818[i][2]).

Cease-and-desist orders are flexible, multipurpose tools for requiring the affected party to take or to stop certain actions or to take certain actions only after Agency review and approval. They have been used by the Agencies to address a wide variety of banking problems, ranging from unsound loan administration to weak management and violations of law. Typical orders might restrict the payment of dividends, require improved capital ratios, or mandate the development of programs to improve earnings. Since 1989, the Agencies have been explicitly authorized to require the affected parties to take affirmative action to correct conditions resulting from the violation of law or from the unsafe or unsound practice that caused the order to be issued.[14]

Removal of Deposit Insurance

The FDIC may terminate a bank's federal deposit insurance pursuant to Section 8(a) of the FDI Act (12 U.S.C. Section 1818[a]). The statute generally provides that the FDIC may initiate a proceeding once it determines that there exist violations of law or unsafe or unsound practices that require the termination of insurance. Insurance also may be terminated if the FDIC determines that the institution is in such an unsafe and unsound condition that it may not continue operations as an insured bank. Once a final order terminating insurance becomes effective, following notice, hearing, and appeal, the insured deposits of the bank remain insured, less withdrawals, for a period of at least six months or for as long as two years, as the FDIC might decide. Additions to existing deposits and new deposits after final termination are not insured. In similar circumstances under Section 8(a), the FDIC may suspend deposit insurance if it has reason to believe that the insured bank has no tangible capital left under the capital guidelines or regulations of the appropriate Agency.

[14]12 U.S.C. Section 1818(b)(6). This section specifically lists the following types of affirmative action that affected institutions may be required to take: 1) restitution for certain losses; 2) restrictions on asset growth; 3) disposal of any loan or other asset; 4) rescission of agreements or contracts; and 5) employment of qualified officers and employees who may be subject to approval by the Agency. It should be self-evident that not all onerous banking regulations proceeded from FDICIA alone.

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Forfeiture of Bank Charter

The Office of the Comptroller of the Currency (OCC) may initiate suit in federal court to determine whether directors of a national bank have knowingly violated the National Bank Act or the Federal Reserve Act. Upon judgment of such violation, the rights, privileges, and franchises of the bank are forfeited.[15] In such circumstances, the bank probably would be liquidated, or a bridge bank might be created.

Conservatorship

Prior to FDICIA, the OCC could, without notice or a prior hearing, appoint a guardian or caretaker for a national bank, called a "conservator," whenever the Comptroller determined that one or more of ten conditions listed in 12 U.S.C. Section 203(a) and (c) existed with respect to that bank. The conditions listed that were most directly relevant to this paper included:

1. The bank is in an unsafe and unsound condition to transact business, including having substantially insufficient capital or otherwise, and

2. The bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the bank's capital to be replenished without federal assistance.[16]

Even when the listed conditions were satisfied, the language of the National Bank Act made it clear that the appointment of a conservator by the OCC is discretionary.

The OCC's objectives in appointing a conservator, who may be the FDIC, are to take possession of the bank and to take such actions as might be necessary to conserve its assets pending disposition of its business. The conservator acts with all the powers of the bank's shareholders, officers, and directors, and unless the OCC prohibits his

[15]12 U.S.C. Sections 93(a) and 501(a). Directors of national banks may be personally liable for damages caused to the banks or to others because of their consensual violations of the National Bank Act or the Federal Reserve Act.

[16]12 U.S.C. Section 203 was completely rewritten by FIRREA in 1989. The general counsel of the Federal Reserve Board, Walter Wyatt, drafted the original Bank Conservation Act (12 U.S.C. Sections 201–211) as Title II of the Emergency Banking Act of March 9, 1933 *Federal Reserve Bulletin* (19)(3): 115; see also Jesse Jones (1951: 21–22). The former condition for appointment of a conservator under Wyatt's version of Section 203 was "whenever [the OCC] shall deem it necessary in order to conserve the assets of any bank for the benefit of the depositors and other creditors thereof." In other words, no explicit finding of actual or potential insolvency was required, but former Section 203 provided explicitly that a conservator was to have all the powers of a receiver, in addition to powers necessary to operate the bank. Jones (1951: 22) notes that the title "conservator" was "akin to receiver but less harsh on the public ear." The original object of conservatorship "was to stave off creditors long enough to rehabilitate a bank rather than let it go into receivership."

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doing so, he may continue to operate the bank as the same legal entity.[17] The conservator may receive new deposits and use them to satisfy the claims of previously existing depositors, which does not necessarily matter much if the grounds for his appointment do not include the bank's actual or prospective insolvency. However, the capacity to use new deposits to pay off old deposits is an important (albeit economically unsustainable) power if the bank actually is or is likely to become insolvent. The bank may challenge the appointment of a conservator within 20 days (12 U.S.C. Section 203[b][1]), but conservatorship usually continues until the OCC (together with the FDIC, if it has been appointed as conservator) decides that the conservatorship may be ended safely and the bank either is permitted to resume business or is sold, merged, or liquidated (that is, a receiver is appointed), etc.[18]

Receivership

Before FDICIA, the OCC could appoint a receiver for a national bank whenever "after due examination of its affairs," he found that (a) the bank had forfeited its charter for knowing violations of the National Bank Act;[19] (b) a creditor had obtained a judgment against the bank that remained unpaid for at least 30 days; or (c) the bank had become insolvent (12 U.S.C. Section 191). An additional ground for appointment of a national bank receiver before 1934 was failure to redeem circulating national bank notes—in fact, it was on this ground that most court cases involving national bank insolvencies were decided before 1934, when circulating notes were terminated.[20]

[17]12 U.S.C. Section 206, as amended in 1989 by FIRREA. Previously, Section 203 provided that a conservator had all the rights and powers of a receiver and that the rights of all parties with respect to a conservator were "the same as if a receiver had been appointed," which limited the conservator's capacity to maintain uninterrupted banking services (for example, claimants against conservatorships could not have obtained full satisfaction of their claims—to the possible prejudice of other claimants—without judicial approval). Now, a judicial order might be necessary to *prevent* the conservator from satisfying some claims in full, to the potential detriment of other claimants.

[18]12 U.S.C. Section 205. Former Section 205 provided for termination (other than by "reorganization" under Section 207 [repealed in 1989] or conversion into receivership) whenever the OCC decided that it could safely be done and would be in the public interest.

[19]The knowing violations of the National Bank Act prohibited under 12 U.S.C. Section 93 were not amended by Title IX of FIRREA, which established civil money penalties for violations of the Act. Those knowing violations include the acceptance of deposits after the commission of an act of insolvency, or in contemplation of such an act (12 U.S.C. Section 91). This prohibition against the acceptance of new deposits while knowingly insolvent was enforced frequently until 1934 (when federal deposit insurance commenced), but has been enforced only rarely since then and not, to the author's knowledge, within the last 20 years.

[20]See 12 U.S.C. Section 192 and cases cited thereunder. Many lawyers are deceived by looking only under Section 191 for cases involving insolvent national banks.

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Since 1933, the insolvency of a national bank has generally been determined by a "maturing obligations" test—that is, capacity to meet maturing obligations, rather than a mere excess of liabilities over assets. However, before 1933, occasionally since 1933, and again after FDICIA, insolvency has also been determined by what amounted to a balance-sheet test (an excess of liabilities other than capital over assets, at book value). That is, a national bank might dishonor maturing obligations or its own circulating notes (pre-1934), or close its doors (which often happened during panics, when circulating notes could not be redeemed in specie), but the final regulatory determination of insolvency, reflecting the condition of the bank's balance sheet, among other factors, would be made by the Comptroller. [See *Smith v. Witherow*, 102 F.2d 638 (3d Cir. 1939).]

It is worth noting that the balance-sheet test for insolvency could rely fairly safely on book-value accounting in the past (pre-1933) because national banks then held no long-term assets whose market value would have differed significantly from book value, or historic cost. Also, cash-accounting principles were commonly used for banks prior to 1933, which meant that divergences in asset values due to the lags of accrual accounting usually did not exist. The general transition to historic cost accounting principles for banks occurred pursuant to a supervisory agreement in 1938 (see Mengle 1991, and Simonson and Hempel 1992).

Whichever test is applied for the appointment of a national bank receiver under 12 U.S.C. Section 191, the OCC's decision is entirely discretionary and cannot be compelled by the bank's creditors, although it may be attacked by the bank itself. Once appointed, the receiver (usually the FDIC for insured banks) ordinarily has no mandate other than to take control of the bank's assets and affairs, wind up its business, and close the bank (12 U.S.C. Sections 191 and 194). After all creditors have been paid in full, the OCC (or the FDIC, if acting as receiver) must call a shareholders' meeting to determine whether the receiver, or an agent elected by the shareholders, should complete the distribution of receivership assets to shareholders or should further manage affairs (12 U.S.C. Section 197).

Bridge Banks

Bridge banks share many common attributes with and serve many of the same economic objectives as national bank conservatorships. The principal difference is that bridge banks are organized and administered by the FDIC, while the OCC appoints national bank conservators. In effect, the bridge bank power enables the FDIC to take over failing banks even though the FDIC is not a charter-issuing agency.

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Bridge banks were authorized under Section 503 of CEBA (1987)(now 12 U.S.C. Section 1821 [n]). Previously, in states without conservatorship statutes, there was no orderly way for the FDIC to encourage state regulators to close state-chartered banks while assuring those regulators that the banking operations of the closed banks would continue—occasionally an important factor in establishing political support for the closure. The CEBA provisions regarding bridge banks required actual closing of an insured bank before a bridge bank could be chartered to continue its operations (former 12 U.S.C. Section 1821[i][1]).

FIRREA (1989) amended the bridge bank provisions of the FDI Act to authorize the chartering of a bridge bank whenever it is determined by a court, the appropriate administrative body, or the appropriate Agency that one or more insured depository institutions are either "in default" (that is, a conservator, receiver, or other legal custodian is actually appointed) or "in danger of default" (that is, it is determined either that the insured institution cannot meet maturing demands or obligations without federal assistance or that the insured institution has incurred or is likely to incur losses that would substantially deplete all of its capital without federal assistance).[21] Thus, the creation of a bridge bank no longer need await a chartering authority's formal closing order and becomes largely discretionary on the part of the FDIC.

After the FDIC's board of directors authorizes the organization of a bridge bank, the OCC *must* charter it (12 U.S.C. Section 1821 [n][1][A]). A bridge bank is deemed a new, insured national bank from the time it is chartered, "in default" for the purpose of abridging certain contractual obligations of the former depository institution, operating without capital, and *not* an agency, establishment, or instrumentality of the U.S. government.[22] In order to organize a bridge bank, the FDIC's directors must determine that at least one of the following conditions exists:

1. The costs of operating the bridge bank would not exceed the costs to the FDIC of liquidation;
2. The continued operation of an insured bank is essential to provide adequate banking services in the community; or
3. The continued operation of the former bank is in the best interest of its depositors (12 U.S.C. Section 1821 [n][2][A]).

[21]FIRREA Sections 204 and 214; 12 U.S.C. Sections 1813(x) and 1821(n). These criteria are essentially the same as those for appointment of a receiver or conservator of a national bank, except for the new balance-sheet test and having fewer than five directors, added by FDICIA.

[22]12 U.S.C. Section 1821(n)(1)(E), (n)(2)(A)–(C), and (n)(5)(A).

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A bridge bank may assume only the deposits and other liabilities and purchase only the assets of the defaulting insured bank that the FDIC determines to be appropriate.[23] A bridge bank generally can exercise all the corporate powers of a national bank, without having to observe national banks' capital adequacy requirements. Its existence is limited to two years, but this may be extended by the FDIC for up to three additional one-year periods (12 U.S.C. Section 1821 [n][4] and [9]). The statute anticipates that any bridge bank will be merged, sold, or otherwise disposed of during its existence (12 U.S.C. Section 1821 [n][10]-[11]). If not, the FDIC is to dissolve it and commence liquidation, with the OCC appointing the FDIC as receiver (12 U.S.C. Section 1821 [n][12]). Hortative language in the statute (12 U.S.C. Section 1821 [n][3][B]) apparently contemplates that existing borrowers and depositors continue to be accommodated.

Changes Effected by FDICIA

FDICIA changed the supervisory intervention and closure regimes described above only minimally, but added a new set of intervention powers: capital-based prompt corrective action (Sections 131–133 of FDICIA), designed to impose a supervisory duty to avoid or minimize loss to the deposit insurance funds and, ultimately, to the taxpayer. Under prompt corrective action, there is essentially an increasing degree of supervisory intervention in an insured institution's affairs as the leverage capital ratio (capital vs. total assets) or the risk-based capital ratio (capital vs. risk-adjusted or weighted assets) declines.

Five capital ranges are established for open depository institutions, ranging from well-capitalized to critically undercapitalized. The Agencies are authorized to define the capital adequacy ratios for those ranges. Only the first two ranges (well-capitalized and adequately capitalized) may be exempted from prompt corrective action as capital adequacy declines. Once capital reaches the critically undercapitalized level, currently defined as a Tier 1 leverage capital ratio of 2 percent or less, the institution must be closed within 90 days, unless the Agency grants an extension that can be renewed only once (conservatorships and bridge banks are exempted from this rule). While Agency discretion played an important role in the pre-FDICIA supervisory regimes, that discretion has been severely limited by the prompt corrective action provisions in order to mandate the abandonment of supervisory forbearance by the Agencies. Rightly or wrongly, Congress

[23]12 U.S.C. Section 1821(n)(1)(B) and (n)(3)(A). Thus, the FDIC has virtually complete discretion to determine the composition of the liabilities and assets of a bridge bank.

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believed that it was forbearance that either caused or increased the losses incurred by the Resolution Trust Corporation and the Bank Insurance Fund during the 1980s.[24]

Other relevant changes made by FDICIA include:

Enforcement Actions. The criteria for issuance of cease-and-desist orders were amended by adding the receipt in an institution's most recent report of examination of a less-than-satisfactory rating for asset quality, management, earnings, or liquidity. If the deficiency goes uncorrected, the appropriate Agency may deem the continuance of the deficiency an unsafe or unsound banking practice (12 U.S.C. Section 1818 [b][8]).

Conservatorship. The standards for appointment of conservators of national banks were unified with those for appointment of the FDIC as conservator of insured state-chartered depository institutions (12 U.S.C. Section 1821 [c][5], effective December 19, 1992). The principal new feature of these revised standards is the explicit authorization of a balance-sheet test (an excess of liabilities over assets) as grounds for appointment of a conservator, as distinguished from the mere inability to satisfy claims as they mature.

Receivership. The receivership section of the National Bank Act (12 U.S.C. Section 191) was modified, effective December 19, 1992, to provide for the appointment of the FDIC as receiver of national banks *without prior notice or hearings* on the same unified grounds as for the appointment of the FDIC as conservator, including the explicit authorization of a balance-sheet test. Also, a receiver or conservator may be appointed if a national bank has fewer than five directors. No prior examination is required for the OCC to be authorized to appoint a receiver.

FDICIA made no other substantive changes in the bank supervisory intervention and closure regime. Of all these changes, it is reasonable to predict that the capital-based intervention standards and the procedures for prompt corrective action will prove to be the most far-reaching. FDICIA also contains language aimed at encouraging studies of market-value accounting and limiting the use of the Federal Reserve Banks' discount windows, but the risk-adjusted FDIC assessments probably will prove to be the most significant supervisory change other than the supervisory interventions foreseen under prompt corrective action. In general, it is fair to characterize FDICIA as a market-

[24]Most of the relevant statutory amendments made by FDICIA are in the FDI Act. See generally Richard Carnell (1992) on prompt corrective action under FDICIA and on other legal issues related to FDICIA. On the costs of forbearance, see Thomas Woodward (1992) and James Thomson (1993).

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oriented attempt to realign the legal and economic incentives underlying supervisors' and bankers' behavior in the same taxpayer-cost-reducing direction and away from forbearance.[25]

After FDICIA: The Evolving Legal Agenda

The enactment of FDICIA essentially reflected congressional frustration and disappointment regarding the performance of depository institutions' supervisors and regulators over the prior decade. Only the national credit union industry, among depository institutions, has managed to avoid (thus far) the same degree of congressional scrutiny and mandate for supervisory intervention. However, it is reasonable to expect that the emergence of problems in that industry, albeit unlikely, also would give rise to FDICIA-like legislation.

Insurance companies remain almost entirely regulated by the states, but it is conceivable that high-profile failures of large insurers would generate enough political pressure to cause Congress to attempt to mandate uniform nationwide supervision. Under existing economic conditions, however, very few, if any, large insurance companies are likely to fail. In early 1993, press reports indicated that Representative Joseph Kennedy 2d (D.-Mass.) had introduced a bill to require insurance companies to comply with federal standards analogous to those for banks regarding disclosure of data on racial and demographic characteristics of customers, an anti-redlining measure. It appeared that the Kennedy bill contemplated offering increased access to the Federal Reserve Banks' discount windows in exchange for compliance with federal anti-redlining standards (Garsson 1993).

Securities firms and investment banks also continue to be chartered under state, not federal, law. Federal supervision of the securities industry, however, has been a fact of life since 1933, though state supervision continues to play an important role with respect to small companies, securities issues not registered with the Securities and Exchange Commission, and the like. It is conceivable that a few high-profile failures in the securities industry might trigger a congressional movement toward uniform, federal supervision. Mutual funds essentially are subject to the same kinds of supervision and chartering authority as securities firms and investment banks, but they currently experience a fairly high degree of federal supervision.

Comparatively few new powers are likely to be granted to federally insured depository institutions, given the prevailing mood in Congress. Interstate branching opportunities might arrive soon for well-capitalized

[25]See Thomson (1993), Woodward (1992), and Carnell (1992).

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banks, but increased insurance underwriting powers seem unlikely. It is fair to state that, currently, there is some support in Congress for regulatory relaxation tied to relief of the "credit crunch," but little support for wholesale expansion of banks into new business lines.

The rising importance of mutual funds seems to make them outstanding candidates for the next round of increased federal regulation of financial services companies. In my opinion, such increased regulation is unnecessary and would be unwise because of the implicit guarantee that federal supervision and regulation might carry for mutual fund activities.

For the 103rd Congress, at least, it appears that the principal legal agenda items regarding financial services are reform and restructuring proposals covering the federal bank supervisory authorities. Regarding the Federal Reserve, bills introduced in both houses of Congress during January 1993 would tend to centralize control in Washington of monetary policy deliberations that have been left until now in the hands of Reserve Bank presidents, whose selection is largely determined by directors elected by private-sector member banks.[26]

In the House of Representatives, two bills would restructure the supervisory functions of the Agencies. Under the Gonzalez plan, a new Federal Banking Commission would be created as an independent regulator, and all supervisory responsibilities of the Agencies (except the National Credit Union Administration, or NCUA) would be transferred to it.[27] Under the Leach plan, a new Federal Banking Agency would be created as an independent regulator, with the OCC and the Office of Thrift Supervision combined into it. The new Agency would acquire jurisdiction over bank holding companies with federally insured subsidiaries whose assets are less than $25 billion and whose principal subsidiary is a federally chartered depository institution, together with all stand-alone federally chartered banks and thrift institutions. The FDIC would be the federal supervisor for stand-alone state-chartered banks and thrifts as well as for bank and savings and loan holding companies with assets less than $25 billion and whose principal subsidiary is a state-chartered institution. The NCUA's jurisdiction would remain unaffected. Thus, the Federal Reserve would be left as the principal supervisor of bank holding companies

[26]See, for example, in the Senate, S. 212, introduced by Senator Dorgan (D.-N. Dak.), and S. 219, introduced by Senators Sarbanes (D.-Md.), Sasser (D.-Tenn.), Riegle (D.-Mich.), and Dorgan, both on January 26, 1993. In the House of Representatives, see H.R. 28, introduced by Representative Gonzalez (D.-Tex.) on January 5, 1993, and H.R. 586 and 587, introduced by Representatives Hamilton (D.-Ind.) and Obey (D.-Wis.) on January 26, 1993.

[27]See H.R. 1214, introduced by Representative Gonzalez (D.-Tex.) on March 4, 1993.

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with insured banks as their principal depository institution subsidiaries and with total assets in excess of $25 billion. The Federal Reserve's supervisory jurisdiction would extend to all such bank holding companies' subsidiaries, regardless of the type of charter held. The Fed would also be the principal supervisor for all foreign banking activities and for U.S. activities of foreign banks with worldwide assets in excess of $25 billion.[28]

Whatever further legal reforms are attempted, it might prove useful when analyzing them to bear in mind the principles articulated above regarding competing models of political economy. For example, if we intend to achieve classically liberal results (market-determined outcomes) consistent with a least-government model, it might make more sense to leave the regulation and subsidy of insurance companies at the state, not the federal, level. In matters affecting the expansion of banks' powers, it might prove helpful to consider whether German universal banking models, for example, have anything useful to communicate to U.S. policymakers if the policymakers really intend to follow a classical liberal model of banking structure and regulation in the long run. It just might be the case that German-style universal banking works as it does because of a radically different set of accumulated customs, laws, and assumptions about the optimal method for organizing society than the set that has applied in the United States.[29] After all, one of Hayek's points in *The Fatal Conceit* (1988) is that the evolution of the structure of markets and institutions in capitalist societies is not independent of the societies' moral and ethical codes. If that proposition is true, then it ought to be necessary to change the German universal banking model to fit U.S. society, or to change U.S. society toward Germanic norms, if we set about to accommodate German-style universal banking.[30]

If the optimal structure for the central bank or for the Agencies (federal bank supervisors) becomes the principal agenda item after FDICIA, it would be useful to apply the same principles described above to the analysis. An increased tendency to centralize monetary

[28]See H.R. 1227, introduced by Representative Leach (R.-Iowa) on March 4, 1993.

[29]Minsky (1993), citing Kregel (1992), observes that "the supervision of the German banks [which is located outside the Deutsche Bundesbank, the central bank] is much closer than anything contemplated in the States." Universal banking performs as it does in Germany, I argue, principally because of a greater and more long-standing tolerance for corporatist ideas in German society and under German law than has been the case in the United States. Many important German financial and industrial combinations would not have been allowed under U.S. antitrust laws and doctrines that have prevailed here for the greater part of a century.

[30]An important new article on this topic is Roe (1993).

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policy or supervisory powers in Washington might be consistent with centrally planned political economy models and with some varieties of utilitarianism, even though at first glance this would seem to be repugnant to classically liberal or mildly utilitarian principles. It is unclear that a rhetoric of free markets and free trade could be easily reconciled with the practice of strongly utilitarian or central planning methods in any logically rigorous way (see Neier 1993).

Conclusion

The legal and theoretical history of financial institution structure in the United States carries an ambiguous message for present-day policymakers trying to devise an optimal framework for financial services. At the inception, the dominant political economy model was classically liberal, but strong policymakers like Alexander Hamilton and, later, Nicholas Biddle strove constantly and with increasing success to introduce utilitarian attributes into that framework. A central bank was created, barriers to perpetual corporate charters for financial institutions became eroded, double liability for shareholders was dropped, federal deposit insurance was introduced, and what appears to be an inexorable tendency toward centralization of supervision in Washington has developed.

The recent policy debate has been dominated by questions regarding supervisors' powers to intervene, while the better question might have been whether it would be possible to return to a structure that reduced the role of federal supervisors and left a greater role for the states and for market discipline of financial institutions. If our methods and methodologies increasingly become strongly utilitarian or mildly corporatist, it is fair to ask whether it is logically correct or morally responsible to continue to use free-market (classical liberal) rhetoric to describe what we do. I would prefer to dismantle the structures that ensure increasing levels of centralization of the financial services supervisory framework and to return to the original, classical liberal model. Dismantling federal deposit insurance, separating solvency-support (capital-replacement) lending from the central bank and placing it on-budget at the Treasury, and restoring increased levels of manager and shareholder accountability for the conduct of their financial institutions would seem to be useful places to begin this process.

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Financial Reform and the Enforcement Problem

Gillian Garcia

The title of Walker Todd's paper, "The Evolving Legal Framework for Financial Services," gives the writer ample leeway to cover a wide range of related topics. A book on this subject, for example, might reflect on: the historical evolution of the current financial system; the different political philosophies current at the time the system was set up and later reformed; the political structure and its modus operandi, whether the financial system is centralized or "dual" as in the United States; the extent to which the contemporary financial structure efficiently and equitably meets the economy's structure and needs, both domestic and international.

The discussion would cover banks and other financial firms and would examine the customs, laws, and regulations that govern their operations. In addition, it would examine the enforcement of these laws. It would investigate the ability of the financial structure to take advantage of technological progress. In determining the extent to which the financial system is divided into separate compartments, it would comment on the degree of competition within and among the different segments. That examination would inevitably involve discussion of the powers that different segments possess, whether banks are regarded as "special" or whether "universal banking" prevails.

That, of course, is far too big an agenda for a single paper. In his paper, Todd carefully focuses on one small, but vitally important element in this structure—the legal framework for supervising and

Cato Journal, Vol. 13, No. 2 (Fall 1993). Copyright © Cato Institute. All rights reserved.

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regulating financial services firms in the United States.[1] Todd discusses supervisors' preclosure enforcement activities, but pays particular attention to the criteria for closing failed banks and the changes that were made in them by the Competitive Equality Banking Act (CEBA) of 1987, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, and the FDIC Improvement Act (FDICIA) of 1991. This comment picks up the enforcement theme, presents and analyzes some new interagency data on enforcement actions, and draws attention to the lack of criteria for evaluating enforcement activity.

Tinkering With The U.S. Financial System

It is interesting to ask why the United States has not achieved a greater degree of financial reform than it has. Early in the 1980s, the administration was set on a path toward expanding bank and thrift powers (that culminated in the Senate's repeal of the Glass Steagall Act in 1988) and deregulating the financial service industries. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Garn-St Germain Act of 1982 took steps in that direction (Cargill and Garcia 1982, 1985).

At the latest count, however, Congress and the administration have tightened control over the banking and thrift industries and limited their powers to those permissible for national banks. Why did this happen at a time when Western European countries and Japan were liberalizing their financial systems?

Part of the answer, I believe, lies in the success, until the 1980s, of the system set in place in the United States during the Great Depression. Deposit insurance was credited with stabilizing the financial system and aiding the economy; so, other countries began to adopt similar systems. The very success of the U.S. system caused many analysts to overlook the fundamental agency problem inherent in the system of deposit insurance. The large number of bank and thrift failures revealed this flaw and modern finance theory has analyzed it. Deposit guarantees allowed owners of publicly owned banks and thrifts to incur more risk than debt-holders would have permitted if they had not been insured by the government.[2] This problem blossomed into full scale moral hazard and adverse selection when inflation and consequent high interest rates virtually bankrupted the thrift industry

[1]Other people in this conference and elsewhere have dealt with other aspects of this broad topic.

[2]Conversions from mutual to stock charters were common for savings banks and S&Ls in the 1980s.

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at the beginning of the 80s. Weak and bankrupt thrifts gambled at taxpayer expense. Taxpayers lost $200 billion plus interest. And today weak banks can gamble in the derivative products market.

Ignoring these fundamental problems led the United States to apply a marginal approach to financial reform.[3] More fundamental changes that would have allowed interstate branching, the repeal of the Glass-Steagall Act, unified banking and commerce, as contained in the administration's version of FDICIA, for example, were defeated. The U.S. political system almost requires consensus for legislation to be enacted (Garcia 1993).[4] There was no chance of building consensus on financial modernization when critics characterized these reforms as reckless social experiments at a time when the most important objective was to bring moral hazard in the deposit insurance system under control. Instead of restructuring the financial system, banks' capital requirements were raised, the powers of state-chartered banks and thrifts were limited to those of national banks, early intervention and prompt closure were legislated, supervision increased, and enforcement tightened, in order to protect the deposit insurance funds and the taxpayer from further losses.

In this comment, I will focus on the tightening in enforcement and raise issues associated with congressional supervision of the regulatory agencies' enforcement actions.

Oversight in the Banking and Securities Industries

During the 1980s, Congress became increasingly impatient with the performance of the bank and thrift regulatory agencies. In the United States, direct financing through the securities markets is governed by a caveat emptor philosophy. The role of the Securities and Exchange Commission (SEC) is to make sure that participants in the securities markets have sufficient information to protect their own interests.

The philosophy underlying bank regulation has been different. Most depositors are assumed to be too small, unsophisticated, or busy

[3]In the 1980 and 1982 Acts, to give just three examples: Regulation Q was removed to end cyclical disintermediation, reserve requirements were extended to all depository institutions to help the Federal Reserve control the money supply, and S&Ls were allowed to invest in a wider range of products to reduce their reliance on fixed rate mortgages.

[4]Recognition of a crisis and agreement on a solution were necessary to enact financial legislation under a Republican administration and Democratic Congress (1987–92). President Clinton is currently trying to force legislation through Congress without Republican support, but it is not clear that he can do so.

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elsewhere to spend time and money evaluating the soundness of their bank, thrift, and/or credit union. It has been the regulators' job to ensure the safety of funds deposited in these institutions, by examining the safety and soundness of bank operations and guaranteeing domestic deposits up to $100,000.

For many years, the bank and thrift regulators in the United States maintained a high degree of secrecy over the condition and performance of the institutions they oversaw. Regulators argued (and sometimes still argue) that releasing information about a weak institution could lead to a run, while publishing information about a sound bank or thrift would reveal confidential information to its competitors. The regulatory stance to the public was, "We will guarantee the safety of this institution, so you do not need to worry about it." This was particularly true for large institutions, such as Continental Illinois, Bank of America, and Citicorp which were nursed until they recovered rather than being closed (Fromson and Knight 1993).

There was a degree of ambivalence about releasing data, especially data on individual institutions, to congressional members and staff. While acknowledging that Congress might need some data in order to exercise its legitimate oversight responsibilities, regulators feared that the data could be misused and lead to a crisis. When data were supplied in response to a request, a condition was typically imposed that information be kept confidential. The regulators' advice to Congress can be summed up colloquially, "Leave it to us, we will take care of it."

The 1980s can be viewed as a period when Congress accepted this assertion, deferred to the regulators, trusted that they, together with increased market discipline, could resolve the problems that existed (particularly the thrift problem) if given enough time. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 reflect this trust (Cargill and Garcia 1982, 1985). The regulators had advised that giving thrifts (and, to a lesser degree, banks) greater powers and themselves greater authority could resolve the problems that existed.

By the end of the 1980s, however, Congress had decided that its trust had been misplaced. Hearings held by the Senate Banking Committee in the Spring and Summer of 1988 (U.S. Congress 1988a; 1988b), for example, dispelled that confidence and started Congress and the administration on the long road toward resolving the thrift debacle and the deposit insurance crisis in the FIRREA of August 1989, and FDICIA of December 1991. Congress had also come to doubt the energy and enthusiasm of the Justice Department in pursuing litigation against S&L crooks that the regulators referred to it.

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Title IX of FIRREA

Title IX of FIRREA, which deals with Regulatory Enforcement Authority and Criminal Enhancements, expressed Congress' dissatisfaction with the regulators' use of their disciplinary powers and with the seriousness of the Justice Department's pursuit of S&L criminals. Title IX extended bank-equivalent enforcement powers to the thrift oversight agencies; clarified powers to issue cease and desist (C&D) orders; increased the grounds for and maximum value of civil money penalties (CMPs) that regulators could impose on wrongdoers in the industry; made supervisory records maintained by other regulators available to the FDIC; broadened the prohibition against the employment of persons convicted of dishonesty or a breach of trust in banks and thrifts; and provided for the publication of formal enforcement actions and more data on agency activities.

Section 918 of FIRREA mandates that the federal banking agencies and the Attorney General report annually to Congress on their enforcement activities. The conference report for the Act requires the agencies to provide data on: "informal and formal supervisory, administrative and civil enforcement action(s) initiated and completed in any year and the number and value of civil money penalties" (CMPs); "break down data on investigations, prosecutions, and convictions"; comment on "any concerns about the Justice Department's handling of these matters, including inadequate responses, unnecessary delays, or other problems"; and recommend additional legislation where needed (U.S. Congress 1989: 323). Unfortunately, neither the legislation or the conference report provide guidance on what the enforcement provisions sought to achieve beyond punishing the crooks in the S&L industry. Consequently, it is unclear how to evaluate the contents of the annual reports that Section 918 mandates.

The agencies' reports record the number of formal and informal actions taken each year; the amount of civil money penalties assessed and still outstanding from individuals and institutions; and other enforcement activity. The content and style of the agencies' annual reports differ somewhat. The FDIC names the individuals and institutions punished or involved in enforcement litigation and summarizes progress on each case; the Office of the Comptroller of the Currency (OCC) and the National Credit Union Association (NCUA) do not. The Federal Reserve (FR) names the individuals and institutions against which it assessed civil money penalties. The Office of Thrift Supervision (OTS) provides a summary of cases settled and outstanding against (named) institutions and individuals.

The resulting Section 918 reports prepared by the agencies ultimately reach the desks of congressional staff responsible for overseeing

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the regulatory agencies for use in the annual oversight hearings on the banking, thrift, and credit union industries and their regulators. But how should Congress evaluate these reports?

Has FIRREA Increased Enforcement Activity?

Improving enforcement was an important objective in FIRREA; Title IX is devoted to it. It is possible to discern that enforcement activity has increased since the Act.[5] For example, Table 1 shows available data on the number of formal and informal enforcement actions initiated by the OCC, FDIC, FR, OTS, and NCUA in the years before and after FIRREA. It is, however, more difficult to determine whether regulatory supervision has improved. Is more, better?

For the OCC, formal actions increased in 1990, 1991, and 1992 from low levels in 1988 and 1989.[6] Nevertheless, despite these increases, OCC took fewer formal actions in 1992 than in 1985. The number of informal actions rose sharply (eightfold) between 1990 and 1992. At the FDIC, formal actions rose in the two years following FIRREA, but there was no discernable pattern to informal actions, which peaked in 1988, before the Act was passed. The Federal Reserve's formal actions increased in 1990 and 1991. It is not possible to compare OTS's post- and pre-FIRREA behavior, because OTS's records start in 1990 and the agency says it does not have access to its predecessor's (the Federal Home Loan Bank Board's) records. NCUA's data show that the number of its actions increased eightfold between 1989 and 1990 and have continued to rise since then.

Comparing the Agencies' Enforcement Activities

Table 1 shows that OTS took the greatest number of formal and informal actions in 1990 and 1991.[7] (Data for 1992 from the FDIC and OTS are not available when the paper was written.) NCUA took the lowest number of formal enforcement activities in these two years.

The number of institutions supervised and the value of their assets varies considerably among agencies. Table 2, therefore, examines the

[5]In addition to the legislation, increased enforcement activity may have resulted from changed macroeconomic conditions that weakened financial institutions and/or an easing of budget constraints on the supervisory agencies.

[6]Enforcement activity at OCC may have increased in response to the criticism that Robert Clarke received in the Senate Banking Committee's hearings to consider his nomination for a second term as Comptroller of the Currency (U.S. Congress, 1991).

[7]A press release by OTS says that "the agency's enforcement efforts have peaked and will decline now that we have worked through the bulk of cases tied to the thrift crisis."

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TABLE 1

ENFORCEMENT ACTIONS INITIATED, 1984–92

Year	OCC[a]		FDIC[b]		FR[c]		OTS[d]		NCUA[e]	
	Formal	Informal	Formal	Informal	Formal	Informal	Formal	Informal	Formal	Informal[f]
1984	457	41	218	n.a.	129[g]	n.a.	n.a.	n.a.	4	n.a.
1985	607	20	353	n.a.	214[g]	n.a.	n.a.	n.a.	1	n.a.
1986	329	62	228[h]	455[i]	339[g]	n.a.	n.a.	n.a.	6	n.a.
1987	296	232	236	413[i]	166[g]	n.a.	n.a.	n.a.	0	n.a.
1988	204	127	223	731	155[g]	n.a.	n.a.	n.a.	2	n.a.
1989	275	140	228	670	150[g]	n.a.	n.a.	n.a.	4	n.a.
1990	412	147	255	579	176	298	536	3,129	33	655
1991	488	1,006	356	655	245	297	1,063	1,561	43	462
1992	563	1,221	n.a.	n.a.	295	365	n.a.	n.a.	52	276

[a]OCC *Quarterly Journal*, Vol. 9, No. 1, and OCC's *Annual Reports on Enforcement* for 1991 and 1992.
[b]FDIC's *Section 918 Report to Congress* for 1991; FDIC *Annual Report* for 1988.
[c]Board of Governors of the Federal Reserve System *Staff Report to Congress* for 1990 and 1991.
[d]OTS Enforcement Actions and Initiatives; *Annual Reports to Congress*. Includes civil money penalties which OTS reports separately.
[e]NCUA's *Annual Reports* for 1984–90, and *Section 918 Reports to Congress* for 1990–92.
[f]Informal actions are actions finalized in 1991 as data on actions initiated are not available.
[g]Federal Reserve data from internal agency *Annual Reports on Formal Enforcement Actions* for each year.
[h]Data courtesy of Mike DeLoose, FDIC Legislative Advisor, Office of Legislative Affairs.
[i]Data for memoranda of understanding only.

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TABLE 2

ENFORCEMENT ACTIONS IN 1991 IN RELATION TO THE NUMBER AND ASSETS OF INSTITUTIONS SUPERVISED[a]

	OCC[b]	FDIC[b]	FR[b]	OTS[b]	NCUA
Formal Actions					
per 100 institutions	12.5	4.6	24.9	48.0	0.3[b]
per $100 billion in assets	24.9	33.7	42.8	115.4	23.0[b]
Informal Actions					
per 100 institutions	25.8	8.5	30.2	70.4	3.6[c]
per $100 billion in assets	51.3	61.9	51.8	169.5	247.1[c]
All Actions					
per 100 institutions	38.3	13.1	55.1	118.4	3.9[d]
per $100 billion in assets	76.2	95.6	94.6	284.9	270.1[d]

[a]Number of institutions and their assets are for June 30, 1991.
[b]Actions initiated in 1991.
[c]Actions finalized in 1991, as data on actions initiated are not available.
[d]Formal actions initiated plus informal actions finalized.

SOURCES: Data on enforcement actions came from each agency's annual *918 Reports to Congress* (see Table 1). Data on the number of institutions supervised and their assets were obtained from the Congressional Relations Offices of the OCC, FDIC, FR, and NCUA. Data for OTS came from its *Selected Indicators for all Private Sector Thrifts* 1991.

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number of actions taken:, (a) per 100 institutions supervised, and (b) per $100 billion of assets supervised. OTS has relatively the highest number of formal actions. NCUA had the lowest number of formal and informal actions per 100 institutions supervised, but the highest number of informal actions per $100 million of assets supervised.[8]

Table 3 reports the different types of formal and informal actions taken by the different agencies in 1991. There is some overlap; all agencies issue C&D and removal/prohibition orders and assess civil money penalties. Otherwise there is a surprising variability in the types and/or the names of actions taken by the different agencies. NUCA relied almost completely on informal actions while the Federal Reserve split its activities more equally between formal and informal actions.

This variability illustrates just one of the difficulties faced by the Administration and the chairmen of the House and Senate Banking Committees in their current efforts to rationalize and consolidate the bank and thrift regulatory agencies. Someone, for example, will have to decide whether all of these different enforcement actions are necessary and, if not, which should be continued and which curtailed.

Has Enforcement Improved Since FIRREA?

One can conclude that enforcement activity has increased at all of the bank regulatory agencies since FIRREA. But more activity does not necessarily mean more successful enforcement activity. It is not clear from the legislation or its history how to measure success.

Success depends on what Congress intended, beyond punishing the known criminals and deterring others, by tightening enforcement. Although not clear from the legislation, that additional intent could be of two kinds. The first would lead to prompt closure and less costly resolution, an avenue that Todd pursues in his paper, but it might also involve corrective enforcement actions that lead to recovery, rather than demise. It is in assessing recoveries that the measurement difficulties arise.

Section 918 requires agencies to report the number of actions initiated in any year and the number completed. But completing an action does not necessarily mean that it has been successful. The section also requires that agencies report the value of civil money penalties (CMPs) assessed and the amounts that remain uncollected. The value of CMPs collected is one measure of success, but it is not a comprehensive or completely satisfying one.

[8]NCUA, for example supervised the most institutions (12,653) with only the smallest of the agencies value of total assets ($261 billion) at the end of 1992.

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TABLE 3

TYPES OF ENFORCEMENT ACTIONS INITIATED, 1991

	OCC	FDIC	FR	OTS	NCUA
Formal Actions					
Application Conditions	13				
Capital Directives	1	2	2	95	
Cease and Desist Orders[a]	85	158	53	255	12
Civil Money Penalty Orders	190	11	51	199	21
Conservatorships/Receiverships	0			338	0
Formal Agreements	148		76		
Removal/Prohibition Orders	41	74	46	157	10
Suspensions	3		2	3	0
Trust Power Revocation	0				
Termination of Insurance		81			
Injunctive Actions		25		6	
Part 513 Actions				10	
Orders of Investigation	7	5	15		
Total Formal Actions	488	356	245	1,063	43
Formal Actions as a Percentage of all Actions	32.7	35.2	45.2	40.5	8.5

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Informal Actions					
Board Resolutions	93	223		28	
Capital Plans				150	
Commitment Letters	205			0	
Consent Merger Agreements				82	
Formal Investigations				93	
Letters of Reprimand	152				
Memoranda of Understanding	37	432		28	
Letters of Understanding					462[b]
Supervisory Agreements				325	
Supervisory Letters	519				
Supervisory Directives		821			
Requests for Voluntary Management Changes				34	
Total Informal Actions	1,006	655	297	1,561	462[b]
Informal Actions as a Percentage of all Actions	67.3	64.8	54.8	59	91.5
Total Actions	1,494	1,011	542	2,624	505

[a]Includes temporary and permanent cease and desist orders.
[b]Data for letters of understanding represent final actions as information on actions initiated are not available.
SOURCES: Data from agency *Section 918 Reports*.

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Civil Money Penalties

The Federal Reserve's 918 Report for 1991 states that, between 1975 and 1990, respondents had defaulted on $4.1 million of the civil money penalties it had assessed. Congress perceived the agencies' collection problems as a lack of dedicated follow-through so that Section 918 requires the agencies to report the number and amount of civil money penalties assessed and the amount not collected. It is now possible to evaluate the success of CMP activity according to the ratio of the value of CMPs collected to those assessed.

There has been a marked improvement since 1990 in the ratio of assessments collected at the Federal Reserve. In 1990, less than one percent of the fines levied were paid. In 1991 and 1992, fewer fines were levied, but all were paid in 1991 and virtually all in 1992. OTS appears to have been consistently successful in collecting virtually all of the fines it levied in 1990 and 1991. OCC has collected roughly half of what it assessed in the past three years. FDIC data show a low and variable success rate. These data leave questions. Is it useful to levy CMPs without collecting them? Is it better to levy fewer fines, but collect more of them?

Evaluation Criteria

The questions regarding civil money penalties emphasize that the criteria for evaluating the broader range of supervisory actions are largely undeveloped. The congressional task of assessing whether the regulatory agencies are carrying out their enforcement activities successfully remains an unscientific one. There appears to have been little attention in academic circles to this subject.

A methodological advance is needed. How otherwise will one be able to assess whether, for example, FDICIA's prompt corrective action (PCA) provisions are being faithfully carried out by the different bank and thrift agencies? How will one assess whether PCA is proving successful in achieving Congress's intentions to impede forbearance for troubled institutions and reduce the risk of loss to taxpayers? Some financial regulators, resenting PCA's reduction of their supervisory discretion, could issue regulations in such persnickety abundance as to call the legislation into disrepute.[9]

How then can Congress conduct worthwhile oversight of the regulatory agencies in the post-FIRREA and post-FDICIA environment? A final reality check can be made by examining the numbers of

[9]For example, the American Bankers' Association and others have argued that FDICIA has overregulated the banking industry and contributed to the credit crunch.

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institutions that fail and the cost of their resolution. But it would be better to have some measure of success at an earlier stage of the supervisory process. A comparison among the agencies of the percentage of institutions in the different capital bands (ranging from well-capitalized to undercapitalized institutions) would give some indication of relative performance. Some law firms in Washington keep a tally of the regulations which FIRREA and FDICIA require the regulators to promulgate and the progress that the regulators have in complying with its requirements. But such an approach is mechanistic and overlooks the possibility of regulatory overkill.

More sophisticated tools of oversight are needed. For example, supervisors might be required to reveal their objective for taking a particular action, such as, issuing a cease and desist order, making a capital directive or imposing a suspension. After a predetermined interval, they should evaluate whether each action has achieved its objective. This information should be subject to Congressional oversight. But creative readers may be able to construct additional measures of supervisory success.

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International Financial Deregulation, Trade, and Exchange Rates

Mervyn K. Lewis

Free trade has long been accepted amongst economists as the desideratum for global prosperity. But if free trade in goods is to be secured it needs to be accompanied by unhindered cross-border movements of money, finance and capital. Considerable progress in freeing up financial markets was made during the 1980s. National banking and capital markets were opened to foreign competition and international financial markets expanded. As a result, banks and other financial institutions operating in the large industrial countries now compete to a considerable degree free of interest rate controls, product barriers, and territorial restrictions.

However, developments in the 1990s suggest some contrary trends, namely 're-regulation' in the guise of the Basle capital standards and the perception that the world economy may be coalescing into a set of geographic trade blocs. The European Single Market project and the European Economic Area, the Canadian-U.S. Free Trade Agreement (CUSTA), the North American Free Trade Agreement (NAFTA) and the Enterprise for the Americas Initiative, and (to a lesser extent) the Asean Free Trade Agreement (AFTA), are examples of efforts to remove trade barriers between the countries concerned, including moves to facilitate inter-regional movements of capital and finance and create genuinely transnational markets for financial and other services. To the extent that these agreements incorporate features and concessions which go beyond what might be contemplated at a global level (concessions to some are effectively privileges being denied to others), there is a danger that the agreements might weaken commitments to multilateralism.

Cato Journal, Vol. 13, No. 2 (Fall 1993). Copyright © Cato Institute. All rights reserved.

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If the formation of these trade areas is followed by currency zones—the adoption within the regions of fixed exchange rates or monetary union—it could lead to major alterations to international monetary arrangements and national monetary policies. Some argue that the world is evolving into a tripolar monetary system with the United States, the European Union and Japan serving as the focal point of North American, European and East Asian trade and currency areas. While this view is a considerable simplification in that it overlooks the forces bringing about trade and financial integration at a global level, it is interesting to note that as long ago as 1960, Robert Triffin argued that the stabilization of exchange rate parities within regional blocs, coupled with somewhat looser forms of cooperation between them, could pave the way to a new world monetary order.

This paper examines the inter-relationships between trade integration, financial integration and monetary integration. It first examines the links between trade and finance and the conditions needed for financial liberalization, which go far beyond that of financial deregulation at the national level. Financial liberalization includes the right to sell financial services cross-border, rights of establishment for foreign enterprises, and the rules and regulations covering the scope of their operations. Important differences are found to exist between the approach of the United States and the more market-based one of the European Union. The section after that considers the effects of financial integration where it is argued that more open financial markets have released a vast quantity of financial assets, altering the methods by which payments imbalances are financed and exchange rates are determined. This leads on to the consideration of exchange rate regimes. Governments have dismantled capital controls and opened up financial markets but have tolerated exchange rate volatility, and in this way they have left in place a potentially significant market barrier in the form of exchange rate uncertainty; monetary integration and currency zones are the topics of the last section.

Financial Integration

In his book *The Rise and Decline of Nations,* Mancur Olson observes that significant periods of economic development have followed whenever a much bigger geographic area is created that has internal free trade, citing for illustration the European Union (EU). This example suggests possible links between trade and financial and monetary integration. For many years the EU was a customs union with limited capital mobility, during which time the provisions implicit in the Treaty of Rome for the freedom of trade in financial services lay dormant.

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From this, it has evolved into a single market for both goods and services, free of impediments to capital mobility, and marked by long periods of exchange rate stability. The EU still retains the objective of monetary union in which the single market will be served by a common currency. Thus in Europe trade, liberalization of financial services, and monetary integration are seen as mutually supportive goals. Are the three complementary and does this apply as well in other contexts, e.g., NAFTA? What is needed to bring about financial and monetary integration?

An integrated financial market allows savers to place their funds, borrowers to obtain finance, and banks and other financial institutions to engage freely in financial activities anywhere within the market area. Financial integration consequently requires freedom of capital movements *and* market access for financial services. These two aspects feature prominently—and for good reasons—in recent General Agreement on Tariffs and Trade (GATT) negotiations, and in agreements to establish free trade zones; for example, the text of NAFTA contains chapters on investment, financial services, cross-border trade in services, and temporary access for business persons. Amongst OECD countries, measured output of financial services represents some 5–10 percent of total value added, and the share of the financial services industry in total employment is roughly of the same order. While exchange controls and entry restrictions upon foreign financial enterprises exist, domestic producers of financial services are sheltered from international competition. The benefits of competitive pressures upon domestic financial institutions which come from their removal can be expected to accrue also over time in terms of dynamic efficiency, ensuring that financial institutions have access to newly-developed financial instruments and use best-practice financing techniques. The case of Mexico's financial system under NAFTA comes to mind in view of the relatively underdeveloped markets which exist at present for corporate banking and derivatives.

Liberalization of financial services has significance also for resource allocation in sectors using financial markets. Financial services for the most part fall into the category of services treated by GATT as being complementary to international trade in goods.[1] Also, financial services can be seen as an intermediate input in the production process for non-financial enterprises.[2] On both accounts there must be the

[1]Koekkoek and Leeuw (1987). GATT concepts and the relevance to services are examined by Snape (1990) and Balasubramanyam (1992).

[2]This is a generalization of the idea of putting money balances in the aggregation production function (Prais 1975), building on from the idea of money as a capital good (Friedman 1956).

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presumption that liberalization of financial flows is needed to realize fully the benefits of freer trade in goods (and non-financial services) in much the same way as a unified capital market financial system is desired within national boundaries in order to better service the economy.

But what defines appropriate market access for financial services? International financial services are provided in two main ways: through onshore markets on an establishment basis or via offshore or Euro–markets on a trade-in-services basis.[3] Liberalization of financial services flows thus covers two areas: cross-border transactions and direct foreign investment. The first involves the right to sell across borders, the other concerns the right to establish in the host country. While the two raise different conceptual issues, in practical terms they are closely related.

Cross-border Financial Transactions

Provision of services long distance has long been a feature of international banking. During the 1950s and 1960s banks discovered that some wholesale banking services could be produced externally to the home market. Low comparative production costs, low transportation costs, and less costly regulatory requirements encouraged regulatory arbitrage and the diversion of banking services overseas. These offshore financial markets have few equivalents in other industries offering the same perspectives. First, the markets provide a ready illustration to financiers of the opportunities denied by regulation. Second, the emigration of financial business to the markets create a persistent pressure upon authorities to lighten domestic regulations.

Cross-border transactions have not featured greatly in recent trade negotiations. Nevertheless, cross-border finance continues to be a significant factor for domestic banking markets. This is illustrated by recently collated data[4] for the commercial and industrial (C&I) loan market in the United States. The supply of loans comes from domestic and foreign banks, sourced locally or from overseas locations—principally London, Tokyo (the Japan Offshore Market), and the offshore booking centres in the Caribbean—giving a four-way classification. At the end of 1991, the $777 billion of loans were distributed as shown in Table 1.

The statistics are of interest in documenting both the extent to which loans were sourced from overseas (23 percent of the total) and

[3]Traditional cross-border foreign banking accounts for a small and shrinking component of international banking (see Lewis and Davis 1987: chap. 8)

[4]The data were collated by two researchers at the Federal Reserve Bank of New York (McCauley and Seth 1992).

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the size of foreign-owned banks' share of the C&I loan market (45 percent); this is a larger foreign penetration than in any other sector of the U.S. economy. While there were cost savings to both foreign and U.S.-owned banks from booking loans offshore and circumventing U.S. regulations, the cost advantage was larger for the foreign-owned banks, and whereas the Fed has discouraged U.S. banks from putting U.S. business through their foreign branches, no explicit guidelines against booking domestic business offshore has been given to foreign banks.

TABLE 1

DISTRIBUTION OF U.S. COMMERCIAL AND INDUSTRIAL LOANS, 1991 (PERCENT)

	U.S.-Owned Banks	Foreign-Owned Banks
Onshore Loans	52	25
Offshore Loans	3	20

Regulatory arbitrage in this form blurs the onshore-offshore distinction and by all accounts the U.S. branches and agencies of foreign banks were closely involved in the growth of offshore loans to C&I enterprises, and for the under-reporting of the loans in previous statistics.[5] Thus it would seem that trade in financial services is greatly facilitated by the presence of foreign institutions in the domestic market. When credit is provided borrowers have to be sought out, contact made, borrowing proposals evaluated, the performance of loans monitored and (possibly) work-out arrangements and repayment 'holidays' negotiated. All of these are aided by the information exchanges in relationship banking (Lewis 1992). Increasingly, also, financial services are sold not bought, and the marketing of loans and other products such as derivatives is facilitated by close proximity, in order to establish and sustain business custom.

Foreign direct investment in banking may range from some low-level presence such as a representative office through agencies,

[5]As the U.S. Treasury wrote: ". . . large amounts of off-shore loans to U.S. non-bank residents are not being properly reported. In large part, under-reporting of foreign loans may arise because the non-bank borrower is unsure where the loan is actually booked. This confusion is particularly likely in instances where a U.S. firm is granted a loan from a foreign source but all loan servicing transactions are handled by a bank or other intermediary in the United States" (Letter from Manager, Treasury International Capital Reporting System, Department of Treasury, 1 May 1986. Reported in McCauley and Seth 1992).

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subsidiaries, joint ventures to a full branch operation. The nature of the establishment and the rules and regulations under which the firms operate have to be determined.

Rights of Establishment

When a bank provides financial services across national borders without a presence in the customer's country, it does so under home-country rules. When it does so by establishment, there are three possibilities (or a combination of them): host-country rules; home-country rules; or some agreed or harmonized rules negotiated internationally, bilaterally or as part of an FTA. A number of approaches can be considered.

Most Favored Nation. As laid down in article 1 of GATT, this principle implies that any advantageous measure taken by any contracting party, relating to trade with any other contracting party, shall be applied equally to trade with all other contracting parties. But it is consistent with any domestic policy towards foreign-owned banks. A country is agreeing not to favor banks from one country over those from any other country, not to ensure competitive equality with domestic banks.

Reciprocity. A country may open its financial markets to foreign enterprises because it wishes to gain entry to foreign markets for its own banks. Reciprocity is a mutual concession of advantages or privileges. Some countries may wish to have reciprocity applied with strict numerical parity e.g., bank for bank, branch for branch, and so on. Usually reciprocity is defined as either reciprocal national treatment or as mirror-image reciprocity. Under reciprocal national treatment foreign institutions are given treatment identical to that afforded domestic counterparts in a host country provided that their home country puts banks from the host country concerned on the same competitive footing as domestic institutions. A weaker version—threatened by the United States in terms of the Fair Trade in Financial Services bill—would discriminate against enterprises from countries with financial markets closed to foreigners, not by denying them equal access today but by excluding them from the benefits of any future liberalization in domestic markets unless they first free up their own financial markets.

Mirror-image Reciprocity. This rule would confine the activities of financial institutions in the host country to those which the authorities of the second country allow foreign institutions to conduct in its own territory i.e. country A's banks have the same powers in country B that B's have in A. Use of reciprocity has a number of drawbacks. When two countries or zones seek to apply the principle bilaterally,

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and restrictions are imposed on both sides, the least common denominator of activities permitted in each is left. If applied to institutions from a group of countries a hotch-potch of regulatory rules could result.

National Treatment. A policy of parity of treatment between foreign and domestic banks in like circumstances, or national treatment, was the cornerstone of the United States' International Banking Act 1978 (although reciprocity still operates at the state level), and it is the most generally accepted standard in international banking. It applies host-country rules to foreign and domestic institutions, irrespective of the treatment that domestic institutions receive in the home country of the foreign entity. The idea is that the absence of discrimination in law or practice between foreign and domestic institutions promotes competitive equality between the two.

But the difficulty comes in determining like circumstances and national treatment poses special difficulties when foreign and domestic banking structures differ significantly. The rules may not differentiate between domestic and foreign firms, but they have different impacts upon the two. Interest-rate ceilings, prohibitions upon combining banking with insurance and securities, and restrictions upon branching, for example, may hinder banks from freer markets. National treatment is also a narrow concept, for there are no mechanisms embodied in it whereby the different regulatory structures are directly put to a market test.

These inadequacies are clearly revealed in the North American context. Both CUSTA and NAFTA are built around national treatment. Under CUSTA, Canada discriminated in favor of U.S. banks vis-à-vis other foreign banks by waiving various asset, ownership and branching limitations upon U.S. banking operations in Canada in return for a promise that Canadian institutions would benefit from future liberalization of the U.S. domestic market. When the U.S. Treasury banking reform package lapsed in 1991, the expected returns failed to materialize. In the meantime, the Canadians had instituted their own reforms with the 1991 Bank Act. Banks in Canada now have wider powers than banks in the United States. As a result of this disparity, U.S. banks gain more from national treatment in Canada than Canadian banks receive in the United States (Canadian Bankers Association 1991).

Under NAFTA, the Canadian banks wanted national treatment, which they see as working in American interests, supplemented by some form of symmetry or principle of comparable market access. This is the notion that "the concessions or powers granted to a foreign bank in its operations in the host country must be roughly equivalent

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to those in the bank's home country" (Ibid: 8). In effect Canada sought, unsuccessfully, better than national treatment for its banks. This would have meant the United States accepting within its borders some firms operating under different regulatory rules—something which the Japanese have done for U.S. banks.[6]

Canadian banks are not alone in having concerns about regulatory developments in the United States. For decades U.S. banks have participated extensively in the financial markets of other countries, employing well-established branch networks and conducting securities, life insurance and other financial activities that are still not permissible in the United States. In terms of both branching and activities restrictions upon banks, the United States is increasingly an outlier amongst OECD countries.

Mutual Recognition. The concept of mutual recognition is a powerful and liberalizing one which goes well beyond national treatment. It is based on home-country rules. Each country maintains its own regulatory approach, but when allowing an institution to operate within its borders, a country recognizes as valid for its territory the laws, regulations, and administrative procedures of the institution's home country, and allows the institution to operate under them. At the same time, it pledges not to invoke differences between its own laws and those of the area members so as to restrict the free access of foreign enterprises to its national markets. This means that the country may be agreeing to offer treatment which is more favorable than the treatment accorded to its own institutions in their home market.

Such differences of treatment are embodied in the provisions of the European single financial market with respect to the operation of branches in intra-European markets. This enabled the member countries to avoid the time-consuming search for complete uniformity. Instead, by being willing to ratify the regulatory decisions of other countries when allowing establishment, firms operating under different regulatory regimes can co-exist. It is this process of putting regulatory structures to a direct market test which distinguishes mutual recognition from the concept which emerged in the GATT negotiations on trade in services, that of effective market access.

Effective Market Access. This concept combines the standard GATT principles of most-favored nation, national treatment, non-discrimination and transparency with a "progressive liberalization of laws, regula-

[6]Japanese authorities grant licenses to securities affiliates of foreign banks, provided that the parent bank holds no more than 50 percent of the equity of the affiliate. Consequently, American and European banks are permitted to conduct securities business in Japan through such affiliates—a privilege denied to the European securities affiliates of Japanese banks.

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tions and administrative guidelines relating to banking and other financial services."[7] It is one of the newer principles seeking to go beyond national treatment, based around the argument, noted above, that national treatment may be too narrow a concept when applied to the case of foreign banking organizations entering a highly-regulated financial system; in effect, the extent of adjustment needed by the entrant is so large as to constitute a competitive distortion and market barrier, and some liberalization of the regulatory structure is needed if there is to be meaningful market entry. The General Agreement on Trade in Services calls for successive rounds of negotiations to bring about the liberalization. In this sense, the concept of effective market access is a multilateral equivalent to the regulatory convergence implicit in the EU's mutual recognition and minimum harmonization.

Minimum Harmonization. Mutual recognition has far-reaching consequences for markets because it means that national regulators are surrendering sovereignty not to some overriding federal body, but to regulators of other member states, giving rise to competition among regulations. Naturally, countries are unlikely to recognize rules which are seen to violate necessary minimum standards, leading to uniform legislation on certain fundamental matters. Such minimum harmonization ensures that the most basic rules to which firms must comply are identical throughout the market. Mutual recognition then means that member states are recognizing the *remaining* national rules of other states as equivalent to their own; it is these rules which are subject to the market test.

Regulatory Issues

The process of minimum harmonization requires that interested parties identify those regulations deemed necessary to protect depositors, prevent systemic risk and thus ensure the safety and soundness of the payments mechanism and/or financial system, and to foster competition and an efficient allocation of savings and investment. The difficulty is that countries have different views about how extensive these need to be.

A number of economists have questioned whether banks warrant the attention from government that they have received (see, for example, Capie and Wood 1991). Nevertheless, the notion that banking and finance are somehow special is strongly entrenched.[8] Every country

[7]Statement of the Trade Negotiations Committee of the GATT Uruguay Round, Montreal, 8 December 1988. Reported in *Focus* 61 (May 1983): 15–16.

[8]In particular, Gerald Corrigan (1983, 1986) has argued that banks remain special.

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has a banking system (whereas not every country has a steel or motor industry); in most countries—New Zealand is a notable exception—banks are mainly owned and run by nationals (sometimes governments); and in most banking systems, public confidence is ensured by collective support mechanisms (e.g., deposit insurance, central banking).

It is also the case that extensive regulation of banks remains: entry into banking is supervised; business is restricted by a number of asset-composition guidelines; output is constrained by capital-gearing ratios; safety standards are set; and rules govern banks' ownership links with other institutions. To this list can be added the adoption of the Basle capital adequacy ratios by most OECD member countries, a process which has been referred to as re-regulation.

In fact, the decade of the 1980s was not so much one of deregulation, but rather one when the regulatory rules were rewritten, the "age of regulatory reform" (Button and Swann 1989). Regulatory reform is a better description than deregulation which implies the complete abandonment of regulation instead of selective removal and a shifting emphasis. Much of what passes for deregulation consists of a change from regulatory to market actions and within the category of regulatory actions, from structural controls to conduct and protective measures, as the authorities adapt monetary controls in an altered environment. This is because regulatory controls often perform a number of functions, as shown in Table 2. The table considers a number of commonly used regulatory tools and seeks to identify for each the principal aim along with the subsidiary goals or byproducts. Thus liquidity ratios, which were imposed mainly for monetary policy purposes, may have served to re-assure depositors and thus bolster confidence in banks. Interest rate ceilings were used to facilitate the operation of monetary policy, but they also prevented competition for deposits of the sort which took place by U.S. savings and loan associations in the early 1980s. Close quantitative restrictions over bank lending acted as a substitute for bankers' own prudence, so regulated banks were generally safe lenders. In the new framework, capital adequacy ratios ostensibly reinforce bankers' caution, but also act as the principal constraint upon banks' balance-sheet expansion. Further, by giving a low risk weighting to government securities, the new standards may also serve to direct bank resources into the financing of public sector deficits.

Nevertheless, important changes to liberate financial markets have taken place in industrial countries. Controls over interest rates have been either removed or lightened. Selective controls upon consumer installment credit and lending directives are little used. Long-standing divisions between banking and other financial institutions are coming

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TABLE 2

CLASSIFICATION OF FINANCIAL REGULATION

	Stability of Payments System	Stability of Financial System	Investor Protection	Competitive Efficiency	Monetary Control
Interest Rate Controls	○	○			◆
Lending Controls, Reserve Requirements	○	○			◆
Prudential Controls					
Supervision of Balance Sheets and Lending Policies	○	◆	○		○
Deposit Protection Schemes	○	○	◆		
Product Market Barriers					
Specialization of Banks	◆	○	○		
Separation of Banking/Securities/ Insurance	○	◆	○	○	
Restriction of Range of Markets		◆	○		
Business Policies					
Bank-commerce Ownership Links		◆	○	○	
Cartel-merger Policies			○	◆	
Information Disclosure		○	◆	○	
International Barriers					
Cross-border Capital Controls		○			◆
Control of Cross-border Financial Services			◆	○	○
Restrictions on External Location		○		○	◆
Restriction on Establishment by Foreign Institutions	○	○	○	◆	○

◆ Represents principal aim of control. ○ Represents subsidiary goal or byproduct.

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down. Barriers to the participation of foreign financial firms in domestic markets have been lowered. Exchange controls and restrictions upon capital movements have been eased, although cross-border constraints upon insurance and pension fund portfolios remain. Access of foreign borrowers to national capital markets is much freer.

The extent of financial liberalization is, however, far from uniform. The regulatory divergences across countries are not qualitatively different from those in the markets of the EU, and might be resolved in much the same ways. The administrative barriers which impede the free supply of services across Europe are to be removed through a combination of minimum harmonization and mutual recognition. Certain restrictions are placed upon banks' activities in order to qualify for the 'common passport' which allows the bank to branch across the union.[9] Thereafter, regulatory convergence is brought about by two factors: mutual recognition and competition among regulators. A country is free to institute standards more stringent than those specified in the minimum harmonization rules, but the standards apply only to the operations of its home banks; their firms will prosper if higher standards are valued by the market. Regulation more lax than in other countries could arise where standards have not been harmonized; these firms will gain the business of those unconcerned by the lower standards. At the same time, services can be exported and imported freely across national borders from countries both inside and outside the group. The effect is to allow a variety of regulatory norms to co-exist within the financial markets of the EU. In this way, transactors' freedom to choose the desired mode of financing and type of financial firm with which to deal will to a large degree decide what types of regulations prevail.

Much the same forces can be seen to operate internationally. Some form of mutual recognition is implicit whenever a foreign bank is allowed to enter a country's financial markets. Most prudential rules make sense only when related to the entire, world-wide business of a bank. Capital adequacy is an example, and rather than re-regulation, the Basle standard might be viewed more optimistically as the multilateral equivalent of the minimum harmonization and regulatory convergence implicit in the EU's home-country rules. Much like the application of speed or alcohol limits on the roads, the standards impose collective restraints but otherwise preserve rights of access. A certain guarantee against heavy-handed regulation comes from the globaliza-

[9]These are contained in directives which regulate minimum standards for a banking license, consolidated supervision, published accounts, supervision over major shareholders and participation in non-banks, and capital adequacy requirements.

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tion of financial markets and the regulatory arbitrage that it permits. When banks are able, through their overseas operations, to choose the most favorable regulatory environment for any line of business, a government's monopoly of regulation is eroded. The existence of competing regulatory norms also leads to some privatization of regulation by rating agencies, bank analysts, auditors, and various professional bodies. A further element of market discipline comes from the co-insurance inherent in a thicker layer of capital, shifting part of the burden of supervision from the regulatory authorities and onto the market.

Financial Integration and the Balance of Payments

Financial liberalization and the increased integration of banking and capital markets, either globally or across free-trade areas, have important implications for economic policy and exchange rate determination. Because of the competitive threat of offshore banking, monetary policy mechanisms which involve a tax effect are of limited use. Currency substitution may yet restrict further the utility of domestic money-supply targeting. Policymakers may also find themselves in the unfamiliar position of having the capital account drive the current account, rather than the reverse causation implied in old Keynesian models, and this can lead to policy confusion about the balance of payments.

Payments Imbalances

With the onset of floating exchange rates in 1973, the current account replaced the overall balance of payments as an indicator of the need for adjustment in a country's macroeconomic policies.[10] A current-account deficit is the deficiency between exports and other overseas earnings, and imports but it is also the difference between a country's domestic investment and savings. In the new environment of international financial laissez faire (Corden 1983), saving and investment decisions are made by 'consenting adults' who, we must presume, know what they are doing. The current-account surplus or deficit simply reflects, in the aggregate, these individual saving and investment decisions.

[10]See Salop and Spitaller (1980). The current account is a leading variable among the list of indicators for disciplining international policy coordination (see e.g., Crockett and Goldstein 1987); and current-account developments, actual and prospective, are a prominent component in the IMF's conjunctural review and medium-term projections in its annual *World Economic Outlook*.

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Three equivalent definitions can be provided for a current-account deficit (CAD):

$$CAD = Z - X = K - \Delta Res$$
$$CAD = (C + I + G) - Y$$
$$CAD = (I - S) - (T - G)$$

The first is obtained from the balance-of-payments identity and defines the current-account deficit as the private capital inflow and borrowings from overseas (K) net of the authorities' addition to international reserves (ΔRes). The second expression relates the deficit to the excess of absorption, $A = C + I + G$, over domestic income (Y). In the third equality, the current-account deficit is presented as equal to the excess of private sector investment (I) over private sector savings (S) and the government budget surplus ($T - G$).

During the late 1980s and early 1990s the main current account deficits were accounted for by the Anglo-Saxon countries—the United States, Britain, Canada, Australia, and New Zealand. Policy discussion invariably centered around a number of national issues. One strand emphasized the need for overseas borrowings to finance the adverse growth of imports relative to exports, and questioned whether the borrowings were desirable or sustainable. Another focused on the trend of spending relative to domestic production, with the current-account deficit sometimes simply equated with a national price-level or inflation rate which was too high. However, the developments must also be seen against the backdrop of the removal of exchange controls, deregulation of credit in the banking and financial system, and increased financial integration at regional and global levels. The deficits that a country incurs on the current account of the balance of payments must of course be matched by surpluses on the part of countries with which it has trading and financial relationships. These individual national relationships form part of a global pattern and can be understood only within the framework of a general equilibrium involving the spending and saving decisions of nationals of many countries.

In models of intertemporal equilibrium (e.g., Sachs 1981; Frenkel and Razin 1987), the price of present consumption in terms of future consumption is the real rate of interest, which will be the higher the stronger the community's preference for present goods. But individuals have very different sets of preferences for present and future goods, and by means of the exchange of financial assets they may trade present current-account deficits/surpluses for future surpluses/deficits in much the same way as they trade goods and services. It then follows that if the comparative advantages in present and future goods differ widely across countries (as they surely do between, say,

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Japan and the United States) then even large current-payments imbalances among countries can persist, contrary to those views that focus only on the current transactions of the balance of payments. Neither the supposed prodigality of some nations, nor the thriftiness of others, should serve as the norm of internationally responsible behavior, since presumably citizens of the countries can be adjudged to be making decisions which accord with their own best interests.

What further follows is that if such imbalances are to be reduced, it is not sufficient to correct the imbalances resulting from merchandise and service-trade flows, ignoring the disparities between national preferences for present and future goods; the current-account balance, however defined, can no longer be reliably targeted by traditional instruments such as monetary policy. Suppose, for example, that it is the capital account that overshoots; that is, more capital is brought in than is required to finance a given current-account deficit. If the authorities, fearing that the resulting current appreciation would widen the deficit, jam on the monetary brakes and push up interest rates in an attempt to control the deficit by dampening domestic demand, they only make things worse by encouraging capital inflows.

Viewed in this global setting, the use of macro- and micro-policies *purely* to reduce the size of the current-account deficit to some tolerable level is neither practicable nor desirable. Given the level of world saving, investment expenditures for any one country will be governed by the marginal productivity of capital domestically relative to that of other countries, the current-account imbalance always matching ex post the gap between domestic investment and saving. Reduction of the current-account deficit below that level would reduce economic welfare both in that country and the world. Those who frown upon current-account surpluses or deficits are saying that there should not be any net international lending or borrowing.

The process of global financial integration makes the essential assumptions of intertemporal theory more nearly realistic and the policy conclusion succinctly put by Richard Cooper (1981: 269) more relevant:

> In the context of overall savings-investment analysis, countries should not take any particular view of their current account positions at all. Some will draw savings from the rest of the world, others will invest in the rest of the world. Nothing is wrong with this. It is as it should be.

The conclusion is that the authorities should confine themselves to the task of monitoring the internal balance, leaving the current-account imbalance and the level of private debt to adjust to their policy setting. It is in this policy sense that the deficit "does not matter".

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Exchange Rates

The processes outlined above imply that any increase in spending and decrease in saving by the deficit countries reflects a decrease in spending and increase in saving by the surplus countries. To the extent that such changes simultaneously alter both the capital-account and the current-account balances, the international economy is spared the shocks of exchange rates adjusting too sharply to bring about short-term adjustments to trade flows. The clearest illustration of such a smooth payments mechanism (where adjustment costs are either absent or minimal) is an association of regional economies in a monetary regime with a single currency. In a regional payments system, a member economy may indeed sustain current-account deficits with other regions more or less indefinitely, since the deficits are always automatically financed by capital inflows from the other partners. It would be regarded as the height of absurdity, for example, for California to worry about its state of payments with other parts of the union. One reason is because the free movement of goods and labor across state borders helps keep regional prices and wage costs in line with those of other states, so that differences in competitiveness which give rise to trade imbalances are less likely to occur.

But the main reason why regional payments imbalances are ignored—to the extent that there is no attempt to even keep statistics on them—comes from the high substitutability between financial claims issued in the different regions. In response to a payments deficit, members of a region issue liabilities or draw down assets, or do both, in order to finance the imbalance. If the securities were exactly those which members of the surplus regions wanted to buy, their prices would remain unchanged, and the current-account disequilibrium would be exactly matched by offsetting transactions on the asset account which left the local economies unaffected. In practice, not all assets are readily transferable (for example, real property). Nevertheless, relatively minor changes are likely to occur in the prices of those assets which are free to move between regions.

This process can conceivably continue until lenders in other regions are unwilling to lend further, or members of the region run out of assets which can be sold off or borrowed against. Most likely, well before these limits are reached, and in response to the growing repayment burden and decline in net assets and wealth, members of the region will revise their economic plans, cut costs and prices, thereby adjusting expenditures and correcting the imbalance of payments. Notably, this correction is brought about without government intervention. It is prompted by no more than the self-orientated behavior of individuals and firms looking to their financial positions in response

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to changes in the physical quantities of the assets in their portfolios. And it may involve little in the way of changes in asset prices so long as members of the deficit regions and financial intermediaries hold large stocks of transferable assets, and portfolio preferences are regionally unbiased.

Something akin to these results obtains for a currency union of sovereign states whose currencies are pegged unalterably against each other. A historical analogue of such a system is the gold standard. Fixity of exchange rates promoted a high degree of integration of goods markets so that prices for tradable goods moved broadly in step with purchasing power parity. At the same time the gold standard was an era of unimpeded international capital movements with capital naturally flowing to regions with high economic returns (Feldstein and Horioka 1980; Bayoumi 1989).

A currency area such as the present European Monetary System (EMS) is different again. So long as each member-nation retains complete *political* sovereignty over its money supply, differential rates of inflation will make periodic exchange rate adjustments among members inevitable, thus introducing exchange risk. The distribution of saving and investment over the whole region will then be conditioned by what view the different transactors take of exchange risk; thus, chronic deficits of, say, Portugal may make German nationals very unwilling to invest in that country if they wish to consume the fruit of their savings somewhere else. In order to overcome the currency risk and all other factors making for a lack of substitutability between claims on the different countries, interest rates in the deficit country must rise, forcing some of the adjustment onto the prices of domestic assets, credit conditions, and incomes and expenditures.

Nevertheless, the general point remains. The growth of international banking, together with the liberalization and globalization of securities markets, can be seen as taking the existing modes of international adjustment some way toward the situations above and seem likely to have altered, in a fundamental way, modes of exchange rate behavior. When Milton Friedman (1953), James Meade (1955), Harry Johnson (1969), and others presented the case for flexible exchange rates, they envisaged that trade flows would dominate foreign exchange markets, so that trade imbalances and purchasing-power parity would enable speculators to judge whether the exchange rate was high or low, and so stabilize its behavior. Now trade surpluses and deficits are being balanced to a large degree by flows of private capital, as under interregional adjustment. To that extent, the need for movements in exchange rates to bring about short-run adjustments to trade flows is largely obviated. Exchange rates will be responding more to lenders'

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preferences for assets denominated in the various currencies than to the trade flows which supply the assets; here we have the basic insight of asset approaches to exchange-rate determination.

Some entities will have a surplus of savings over investment, while others will have more investment opportunities than they can finance and if the area of integration crosses national boundaries, savings and borrowings will also cross national boundaries, sometimes for substantial periods of time. Limits to financing exist internationally as they do domestically, depending on the stocks of internationally transferable assets and the attitudes of borrowing and lending entities to a wide range of economic and financial parameters: private credit can finance deficits up to the point when creditors judge their debtors' positions as being too risky. Currency risk adds an extra dimension, and this leads us into the question of monetary integration.

Monetary Integration

Trade, financial integration, and monetary integration are discussed in one breath in the European context, but, in principle, they are separable. Substantial trade can take place under freely floating rates, as now occurs between Canada and the United States, while virtually complete financial integration of money markets can exist alongside flexible rates, as shown by the Eurocurrency markets. Yet many would question whether a truly free economic market can exist between countries without a common currency, or fixed exchange rates, to facilitate cross-border trade and investment and intensify financial links. As Alan Greenspan (1991: 2–3) notes, "Since the United States is both a free trade zone and a single currency zone, I cannot dismiss the proposition that a single currency is an important ingredient in a successful free trade zone."

Moves towards increased monetary integration between two or more countries can occur in a number of stages. One country may simply give a large weight in its monetary management to the exchange rate of the other country—much as Canada does already with the U.S. dollar. Next a country may unilaterally peg its exchange rate to that of the other country or, like Mexico, fix the speed of a crawling peg link. At the next level, the exchange rate may be jointly set and varied only by common consent, as in the Exchange Rate Mechanism of the EMS. The peg could be soft or hard, the latter implying a nearly permanent link. The exchange rate might then be permanently fixed. Finally, there is a currency union with a single currency and a common central bank.

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Exchange Rate Systems

Fixed parities are regarded as desirable because it is believed that they offer internationally much the same benefits which come in domestic markets from having a uniform national currency. There are economies of information in having a common medium of quotation. As a unit of account, money is needed for pricing commodities and services, for valuing aggregates, and for making the price comparisons needed for international trade and finance. Flows of goods and services should be governed by price- and cost-levels and changes in these, otherwise a country's comparative advantage cannot be known; similarly, capital transactions should be determined by interest-rate differentials. These calculations ought not to be disrupted by major fluctuations in exchange rates. Transactions as well as calculation costs are reduced by having a single medium of exchange. Finally, having a common standard of deferred payments and the reduction of exchange rate risk facilitates long-term planning and the entering into long-term contracts.

Admittedly, fixed exchange rates are not the same as a common international currency. Nevertheless, as we move from floating exchange rates as experienced since 1971 to credibly fixed exchange rates, as under the classical gold standard, information costs, transactions costs, and exchange rate uncertainty can be expected to fall commensurately. Under the classical gold standard there was no essential distinction between domestic and international money. Gold coins circulated freely in the major countries and gold formed the basis, if not the actual means, for the settlement of international transactions. By contrast, under the present 'non-system' there is no recognized international money as such and a variety of different national fiat currencies contribute to the international money supply and serve as standards for international trade and capital transfers. These are the two polar cases and the ranking of the other actual and potential systems compared in Table 3—the gold exchange standard, Bretton Woods, the EMS and European Monetary Union (EMU)—depend much on their perceived characteristics and workings. The table compares the various systems in terms of exchange rates, reserves, inflation control and monetary independence.

The basic case against joining any sort of fixed exchange rate regime is that while a country retains all of its existing policy targets, it loses the exchange rate as a shock absorber, through variations in which the objectives may be achieved. Put another way, it would seem that adding the exchange rate to the list of policy objectives 'uses up' a policy instrument. For reasons now to be explained, any such counting rule argument needs to be treated with care, since the transition from

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TABLE 3

COMPARISON OF DIFFERENT MONETARY SYSTEMS

	Gold Standard 1879–1914	Gold Exchange Standard 1925–31	Bretton Woods 1945–68	Dollar Standard 1968–71	The "Non-System" 1972–	EMS 1979–	EMU
Exchange Rate Regime	Fixed gold parities	Fixed gold parities	Fixed gold parities	Fixed parities	Floating	Fixed parities	Fixed parities/ single currency
Exchange Rate Variability	Within gold export and import points	Gold bullion shipping points	±1 percent	±1 percent	Complete	Bands of ±2.25 percent, ±6 percent, ±15 percent	None
Exchange Rate Realignments	Parities irrevocable		One-sided at discretion of individual country	Possible for non-U.S. currencies	Complete	Require a common decision of all members	None; common currency or irrevocably fixed parities
Nature of Reserves Regime	Gold institutionalized	Gold and gold-backed currencies	U.S. dollar institutionalized	U.S. dollar	National fiat currencies	Mixed; ECU official reserves balances; DM and U.S. dollar used for interventions.	To be determined

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Key Currency	Sterling	Dollars and sterling	U.S. dollar institutionalized as intervention and vehicle currency	U.S. dollar	U.S. dollar as vehicle currency	None institutionalized: evolves to country with strongest currency e.g., DM	New ECU
Balance of Payments Adjustments	Symmetric rules of game	Asymmetric due to sterilization policies	Burdens fell on deficit countries	Burdens fell on deficit countries	No rules of game	Symmetric intervention obligations of all members; but asymmetric sterilization	As in region of country
Inflation Control	Depends on gold price	Link to gold weakened	Relied on United States maintaining gold convertibility	Relied on United States	Depends on individual country	Relies on Germany	Depends on ECU issuing authority (ESCB)
Monetary Independence	Restricted	Limited	Limited	Limited, except for United States, without controls	Possible	Limited, except for Germany	None: centralized monetary policy

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one regime to another seems likely to alter market mechanisms (the Lucas critique) and may enhance the working of other policy measures.

Exchange rate adjustment is not necessary for external equilibria if wages and prices are flexible enough to move up and down in response to economic shocks (Mundell 1961). Nor does exchange rate devaluation shelter those involved from reductions in real incomes and loss of spending power. Rather it is a device for achieving flexibility of real wages and debts more conveniently when prices and wages geared to the local currency are sticky: conditions which apply to large economies with a low degree of openness to trade. In the context of integrated markets and the loss of currency illusion, the effectiveness of the exchange rate weapon is reduced; nominal exchange rates may feed quickly into home prices, creating demands for a further dose of devaluation. There are also some other consequences from the loss of the exchange rate instrument to be taken into account. Eliminating or reducing exchange rate risk in financing decisions makes it easier to finance regional payments imbalances, since debt in one currency is more nearly a perfect substitute for debt in another country.

Changing the exchange rate regime also alters the nature of inflation control. One way of thinking about the implications for inflation control is to note that whether its exchange rate is fixed or floating a country is still responsible for its inflation performance. The issue is whether to do so by means of internal or external stabilization. *Internal stabilization* of the value of money means keeping the purchasing power of national money reasonably stable in terms of goods and services on domestic markets, disconnecting domestic prices from external developments. Thus the freeing of monetary policy under flexible exchange rates makes each country's inflation rate depend essentially on its own national policy (we ignore here complications posed by currency substitution).[11] *External stabilization* involves fixing the value of the domestic monetary unit relative to foreign moneys and foreign prices. The requirement of balance of payments equilibrium without unlimited reserves means that the quantity of (base) money can no longer be used for inflation control. But this sacrifice of monetary autonomy serves to tie the country's inflation rate to that of the fixed exchange rate system.[12]

[11]Under floating rates, the more the portfolios of transactors are diversified among highly substitute assets denominated in different currencies (i.e., the greater is currency substitution), the more the price level in any country becomes the result of the joint outcome of the monetary policies of all countries, as under fixed rates.

[12]Robert Mundell (1969) argued that the true instruments for the respective regimes are the *price* and *quantity* of money. The exchange rate, according to Mundell, defines the price of one money in terms of others. Under flexible rates, this price adjusts to bring

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Fixity of exchange rates under external stabilization is not in itself sufficient for price stability. Some common anchor is needed to ensure that nominal as well as relative price stability results from the common stance of monetary policy. A stable fulcrum could be provided by an outside asset or commodity such as gold, a national currency such as the dollar or Deutschmark, a created reserve currency such as the Special Drawing Right, or a group of national currencies. Where there is one country whose monetary policy serves as the anchor, monetary regimes are sometimes characterized in terms of 'hegemons' and 'implicit contracts' (Frenkel and Goldstein 1988). On this interpretation, as the provider of the key currency in the Bretton Woods System, the United States had an obligation to peg the price of the dollar to gold and conduct stable policies. Other countries accepted dollar leadership to gain the benefits of having a stable international money. The system began to break down in 1968 when the link to gold came under doubt and the subsequent dollar fiat standard fragmented when the United States was seen as generating inflation rather than price stability.

The succeeding 'non-system' can also be interpreted in this vein. Despite having no acknowledged leader, the anchor comes from national policies and especially those of the United States, Germany, and Japan which form the major trading blocs. Success of the system required that these countries follow cohesive, stable macroeconomic policies with stability of exchange rates emerging as a byproduct, and this can be looked upon as its implicit contract. When huge trade imbalances and exchange rate fluctuations put the system under strain, pressures developed both for a new implicit contract in terms of the Plaza Agreement and Louvre Accords, and for stability through other mechanisms such as the EMS and other regional trade arrangements.

Tripolar Currency Zones?

Here we return to the question of whether the formation of free trade areas may signal the development of currency zones and a tripolar international monetary system. There are historical parallels which can be cited, for earlier monetary regimes such as the gold standard were far from universal. An international gold standard was not in place until 1879 and then only the United States, Britain, and Germany permitted full and automatic convertibility. France,

about equilibrium in the balance of payments, while the quanitty of money is used as the instrument for achieving the desired rate of inflation. On the other hand, under a fixed exchange rate regime the price of money is used to tie domestic prices to external prices, while the quantity of money must be varied to keep the balance of payments in equilibrium.

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Belgium, Italy, Greece, and Switzerland constituted the Latin Monetary Union and were effectively on 'limping standards'. Sweden, Denmark, and Norway formed the Scandinavian Monetary Union. There were also countries on a silver standard, notably China and India. As is the case now, small countries usually linked themselves to a convertible currency or had inconvertible currencies. For most of the 1930s and during the Bretton Woods era, the Sterling Area operated and included, at one time or another, Britain and the Commonwealth (excluding Canada), the Scandinavian countries, Iceland, Japan, Argentina, Egypt, and Turkey. Free movements of capital took place within the area, and exchange controls and trade restrictions were applied to other countries. These various sub-systems were motivated by a mixture of factors, including reserve-pooling and trade.

In at least one respect, it is difficult to see how a free trade agreement such as NAFTA can avoid some discussion of monetary issues. Exchange rates can be used as means of trade protection, so that countries in an FTA cannot disregard what happens with exchange rate policies. (For instance, article 107 of the Treaty of Rome declares that each member state must treat its policy with regard to exchange rates as a matter of common concern.) Also, movements of capital and financial services associated with financial liberalization have consequences for exchange rate management. But there is a more compelling reason. Two-way flows of foreign direct investment between the United States and Canada increased substantially once the CUSTA negotiations began as companies positioned themselves to operate in a larger and more competitive market. Similarly, progress toward NAFTA has been accompanied by a record increase in U.S. direct investment in Mexico. Such flows, along with increased trade, expand the groups which are exposed to exchange rate movements and widen the support basis for more predictable (and less costly) monetary exchanges.

In other respects, the arguments for a common currency at the level of an FTA parallel those given above. They stem from the stimulus to intra-area trade by doing away with costly currency conversions, from eradicating exchange rate uncertainty, and by allowing savings and investment to flow more freely. The promotion of trade, in turn, leads to greater competition and increased specialization in areas of comparative advantage, assisting the integration of regions of the FTA into a single, efficient economic market.

Considering the three zones, establishment of a European currency zone—perhaps amongst an inner core of EU countries—still seems the most likely, notwithstanding recent upheavals in the exchange rate mechanism of the EMS. By far the least probable is an East

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Asian trade and currency zone. Trade in East Asia is strongly inter-regional, representing over 32 percent of exports in 1990, and there has been a steady increase in the yen's use for the invoicing of trade and finance in the region, and in some countries' exchange rate policies, although most generally link their currencies to the U.S. dollar, not to the yen (see Frankel 1993). Japan is also quietly replacing the United States as the key partner in the development of East Asia in aid, trade and direct investment, but this is not the result of any deliberate policy initiatives by the Japanese government which has generally resisted internationalization of the yen.

A common currency for North America seems an unlikely development just now, although some nearly fixed exchange rate link—a *de facto* dollar bloc—is not improbable in view of the closeness of trade links (in 1990, Mexico exported 71 percent of its goods to the United States and Canada). In many respects, the position of Canada and Mexico relative to the United States in NAFTA seems not unlike that of the Nordic countries vis-à-vis the EU. They are also small economies next to a large neighbor, with which they have opted for free trade and closer economic integration. To this end monetary policy has been conducted 'as if' they were members, endeavouring to eliminate exchange rate variability relative to the EU. As economic integration in NAFTA increases, the pressures for exchange rate stability may grow. Paul Volcker, for one, has predicted a fixed exchange rate link between the peso, the U.S. dollar and the Canadian dollar by 1996 (Volcker 1991).

Are Fixed Parities Possible?

The Nordic example, and the EMS itself, illustrate the difficulty of maintaining a credible commitment to fixed parities. The policy dilemma can be described in terms of the 'inconsistent quartet' of desirables for international economic relations: namely fixed exchange rates, free trade, full mobility of capital, and an independent monetary policy (Wallich 1972). At best only three of the four can be achieved. Under the gold standard, monetary autonomy was sacrificed. Architects of the Bretton Woods System envisaged that official controls over capital flows would reconcile the inconsistency. The EMS also began with extensive restrictions on capital movements in place. With their removal, (most) member states accepted that the scope for monetary policy independence had to go. But this surrender of sovereignty was not believed by the markets and government resolve was eventually put to the test and found wanting.

One response might be simply to dismiss fixed exchange rates as a constraint on the free working of markets. But that is to ignore that

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under the gold standard there co-existed fixed parities, extensive free banking, and the free movement of capital. Perhaps the sheer volume of internationally transferable funds creates a new problem, yet that ignores the fact that capital flows were extensive in the gold standard era. How was it possible to stabilize exchange rates within narrow bands under the gold standard? Much rested on the mystique of gold: countries on gold were expected to be so forever, and moreover at the same parity. When countries did suspend convertibility temporarily (e.g., the United States during the Greenback era, Britain in the Napoleonic wars and after the First World War), such was the attachment to the historic parities that resumption took place at the old levels. The pound effectively had the same official metallic value from 1717 to 1931, the dollar from 1834 to 1934. As people became convinced of the fixity of rates, the process became self-reinforcing and, to borrow Sir Roy Harrod's (1969) description, capital movements were helpful to the authorities when protecting parity.[13]

The perceived permanence of the arrangements, including the parities, is nowhere more eloquently described than in Keynes (1919: 9–10):

> The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, and in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend. He could secure forthwith, if he wished it, cheap and comfortable means of transit to any country or climate without passport or other formality, could despatch his servant to the neighboring office of a bank for such supply of the precious metals as might seem convenient, and could then proceed abroad to foreign quarters, without knowledge of their religion, language, or customs, bearing coined wealth upon his person, and would consider himself greatly aggrieved and much surprised at the least interference. But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.

This mystique has gone[14] and perhaps with it the possibility of achieving a non-political monetary solution. A government can jettison

[13]Striking evidence of the stability of exchanges under the gold standard is presented by Alberto Giovannini (1992).

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a commodity standard if it gets in the way and it can agree to abide by fixed exchange rates but not follow through with the internal discipline which is necessary for external stabilization to work. People have learnt that governments can alter parity, tamper with the rules of the game and change the monetary system. It follows that hankering after a non-political mode of inflation control is hopelessly naive: adopting a monetary reform is a political act; so is continued adherence, in the face of alternatives, to the rules of a new system.

Without a credible commitment to fixed exchange rates—such as might come from a monetary union which fixes parities irrevocably—many of the benefits of fixed exchange rates discussed above are lost in the sense that the relevant comparison is then not floating versus fixed, but between exchange rates that fluctuate daily and those adjusted by substantial amounts at longer intervals, often after sustained speculative pressures. Floating exchange rates may not be the best approach, but in such circumstances merely the least bad.

Conclusion

A number of points are suggested by the preceeding analysis:

- A free market in banking and financial services is a natural extension and complement to free trade in goods and it features in GATT negotiations, the European single market, and NAFTA.
- Financial integration requires that financial enterprises be allowed to compete free of price, product, and territorial restrictions. While some financial services can (and are) provided cross-border without an office in the customer's country, a commercial presence is needed for many core banking activities, and rights of establishment are important.
- National treatment, the cornerstone of U.S. policy, is a narrow principle which does not provide effective market access for foreign banks when there are substantially different regulatory regimes and market practices. The integration of financial services markets is better promoted by allowing some room for different regulatory structures to co-exist and compete. This will encourage regulatory convergence.
- Increased regional and global integration of banking and finance has undoubtedly widened the range of internationally transferable assets and brought financing modes closer to those which typify

[14]This is evidenced by the remark of Sidney Webb (Lord Passfield) following Britain's suspension of convertibility in 1931, "Nobody told us we could do this" (quoted by A.J.P. Taylor 1965).

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a national economy. To that extent, trade imbalances lose their policy significance and have the potential to be corrected without large exchange rate movements.

- Free trade areas in Europe, North America, and East Asia are based around the liberalization of trade and services, but seem likely to work best with some form of monetary integration involving exchange rate harmony. There are historical precedents for sub-systems within an international monetary system, and with or without NAFTA, Canada and Mexico would seem to constitute part of a dollar bloc.
- Fixed exchange rates are not necessarily at variance with free markets and offer many of the benefits of a common currency, but only if they can be maintained credibly. Otherwise the choice is between (not so) small, continuous movements and larger, intermittent exchange rate adjustments for which the balance of benefits and costs is unclear.

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International Financial Liberalization and Exchange Rate Policies

Anna J. Schwartz

Mervyn K. Lewis's paper covers a lot of ground. It describes the course of international financial liberalization during the 1980s as an extension of free trade in goods and services. The paper speculates on the shape of the world economy if geographic free trade areas, such as the European Single Market (ESM), the North American Free Trade Agreement (NAFTA), and Asean Free Trade Agreement (AFTA), adopt fixed exchange rates or monetary union within the regions. Trade and financial integration at the global level might still develop if the regional blocs did not rule out cooperating with one another, but it is too early to reach a conclusion in this regard.

My comment is organized in three sections. The first one examines links between trade and financial integration. The second one examines the relation of financial integration to the balance of payments and exchange rate policies. The third one examines whether trade and financial integration foster monetary integration.

Financial Integration and Trade

Lewis is straightforward in tracing the advantages of capital movements across countries comprising a free trade area. He shows that cross-border finance to domestic banking markets has grown in importance. Foreign-owned banks supplied almost half the loans extended to U.S. companies, booking significant amounts offshore, unlike domestic-owned banks with mainly onshore loans. The reason for the difference is that the Fed has urged U.S. banks not to book business through foreign branches but has not similarly instructed foreign banks—not a level playing field.

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In outlining six different approaches to the rights of establishment of foreign financial institutions in the host country, Lewis illuminates what an outlier the United States is in imposing a regulatory burden on its banks. When the establishment rule is national treatment, so that foreign institutions must adapt to local regulations, U.S. banks gain from participating in financial markets of other countries, where they are allowed to branch and engage in securities, life insurance, and other financial activities not permissible in the United States. Foreign entities in the United States by the same token have to adapt to restrictive regulations here.

Lewis classifies regulatory controls according to their function in providing stability to the payments system or the financial system, investor protection, competitive efficiency, or monetary control. I am skeptical that these controls actually serve these functions. Lewis details changing aspects of financial regulation for each of seven countries, and observes that most of these have been eased, although financial liberalization is far from uniform. He suggests that globalization of financial markets and regulatory arbitrage give institutions an opportunity to escape government overregulation. U.S. banks still are prisoners at home if not abroad of regulatory fetters.

Financial Integration and the Balance of Payments

Lewis next examines the implications for economic policy of increased integration of banking and capital markets. The analysis is first rate. He questions whether it is any longer useful to accept the distinction between internal and external balance as the appropriate policy framework. Since the current account surplus or deficit simply reflects in the aggregate individual saving and investment decisions, the only reason to regard it as a high priority is externalities in the borrowing process, which would need to be identified to justify intervention. Monetary policy cannot target the current account balance. If in deficit, attributing it to inflation or excessive liquidity, would lead the authorities to raise interest rates, but the effect would be to encourage capital inflows. If in surplus, attributing it to tight monetary policy, would lead the authorities to lower interest rates, but the effect would be to encourage capital outflows.

Capital market deregulation, moreover, removes protection of local savers from foreign competition, since residents of surplus countries can make their savings available in international markets at a higher interest rate than would be possible under restricted capital movements, and residents of deficit countries can borrow more cheaply.

Since comparative advantage in present and future goods differs widely across countries, current payment imbalances can persist. It

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is not only imbalances resulting from merchandise and service and trade flows that need to be reduced but also disparities between national preferences for present and future goods. To object to current account deficits is tantamount to objecting to net international lending or borrowing. Current account imbalances in this sense have no policy significance. They have enormous significance, however, with respect to the industrial structure of the economy. The U.S. current account deficit from 1980 to 1985 imposed a burden on exports that fostered protectionism and foreign exchange market intervention.

I agree with Lewis that there is no case for market failure in the international savings and investment process. I doubt, however, that the authorities will therefore monitor the internal balance and pay no attention to the current account imbalance.

Growth of international banking, accompanied by liberalization and globalization of securities markets, according to Lewis, has altered modes of exchange rate behavior. The case for flexible exchange rates in the 1950s was based on trade flows dominating foreign exchange markets, so speculators could judge from trade imbalances and purchasing power parity whether the exchange rate was high or low and so stabilize its behavior. Since funds flow from the surplus to the deficit regions to finance the imbalance, there is no need for movements in exchange rates to bring about short-run adjustments to trade flows. Exchange rates will respond to lenders' preferences for assets denominated in various currencies rather than to trade flows which supply the assets. This is truly an asset approach to exchange rate determination.

Private credit can finance deficits up to the point when creditors judge their debtors' position too risky. Lewis judges that currency risk adds an extra dimension to this evaluation but, as I note in the concluding section, he exaggerates the importance of currency risk.

Trade, Financial and Monetary Integration

Lewis finds the theoretical charms of fixed exchange rates and a single world currency more alluring than I do. He asks whether it is necessary for a common currency or fixed exchange rates to exist in order to facilitate cross-border trade and investment by nonfinancial enterprises and intensify financial links. Although he acknowledges that substantial trade can take place under freely floating exchange rates and that complete financial integration can exist with flexible rates, he makes the concession with what seems to me regret. It would be more appealing to Lewis if monetary integration could be achieved.

He envisions the stages that would follow, starting with independently floating exchange rates, leading to monetary integration between two or more countries. Canada, for example, gives a big

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weight in its monetary management to the U.S. exchange rate. Alternatively, it could presumably unilaterally peg its exchange rate to that of the United States or fix the speed of a crawling peg link. Another possibility would be to link the exchange rate jointly with that of the United States and then fix it permanently. The final stage would be a currency union with a single currency and a common central bank.

Lewis sees reason to welcome loss of the exchange rate instrument under any sort of fixed exchange rate regime: eliminating or reducing exchange rate risk in financing regional payments imbalances, "since debt in one country is more nearly a perfect substitute for debt in another country." He notes that fixing exchange rates is not sufficient for price stability, since monetary policy across the exchange rate system could be highly inflationary, as happened under Bretton Woods.

In the "non-system" that followed, according to Lewis, the United States, Germany, and Japan were expected to pursue stable macroeconomic policies that would produce stable exchange rates. Instead, huge trade imbalances and exchange rate fluctuations put the system under strain. The result was the Plaza Agreement and Louvre Accord, and a movement for stability through other mechanisms such as the European Monetary System (EMS), and regional trade arrangements.

It is not true, however, that the Plaza and Louvre Accords of the 1980s were prompted by the perception that international trade had been upset, as Lewis states. If anything, these agreements were political actions in response to political motives, namely, that the United States was not confronting its current account deficit while other countries did not have such an option. The political response betrayed a lack of understanding of the view that Lewis has eloquently presented—a current account deficit is not a policy issue. The U.S. political response reflected the loss of export markets by the smoke stack industries.

EMS was a political document to establish a zone of monetary stability among European currencies. Who can believe that Europe is moving toward credibly fixed exchange rates, much less to a common international currency? A single market for goods and services does not require a monetary union. We have the Canadian-U.S. Trade Agreement (CUSTA) and NAFTA, yet no one believes that Canada, the United States, and Mexico should form a currency union. Lewis, however, wonders how a free trade agreement can avoid discussion of exchange rates. Increased trade, he suggests, expands the groups which are exposed to exchange rate movements and widens the support for more predictable and less costly monetary exchanges. I am unaware of such discussions in this hemisphere.

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The view that currency risk inhibits trade and therefore that eliminating currency fluctuations would increase trade among members of the free trade area is not borne out by the record. Currency risk has not interfered with spectacular growth in U.S. and Japanese trade despite volatility of the dollar and yen.

Under a currency union nominal exchange rates cannot adjust to change the real exchange rate. Domestic prices and wages must change to achieve the needed change in real exchange rates. Which is the more desirable adjustment, moving the nominal exchange rate or domestic prices and wages? Is there any doubt that the United Kingdom and Italy helped themselves by leaving the Exchange Rate Mechanism (ERM) in 1992 and that allowing a 15 percent band around the parities of most of the remaining countries will enable them to attend to their pressing national priorities?

Lewis does not give adequate attention to the role of economic shocks that are not uniform among individual countries that adopt a single currency, and the degree of mobility of the labor force as imposing disadvantages on a currency union. The advantage of an independent currency is that it makes possible a countercyclical domestic monetary policy and shifting the real exchange rate without a corresponding shift in the level of domestic prices.

Lewis dismisses exchange rate adjustments as a solution to changes in competitiveness in the face of shifts in relative demand between countries. In integrated markets, he maintains, nominal exchange rate changes create demands for a further dose of devaluation. His emphasis on reduction in information and transactions costs and trouble and inconvenience from doing away with currency conversions is belied by the growth of medium and long-term futures markets.

Lewis regards establishment of a European currency zone amongst an inner core of countries as still most likely, and a nearly permanently fixed exchange rate for North America as not improbable. I am skeptical on both scores. After suggesting that the relevant comparison is not floating versus fixed, but between exchange rates that fluctuate daily and those adjusted by substantial amounts at longer intervals, often after sustained speculative pressures, Lewis concludes that under the circumstances floating exchange rates may be the least bad approach. The conclusion, I believe, comes from the head, not the heart.

In my view free trade is achievable without fixed exchange rates or monetary union. Fixed exchange rates have economic costs, and monetary union is a political pipe dream. Currency risk is not an overwhelming concern of business men.

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Policy Responses to Increased Economic Integration

Robert E. Keleher

The increased openness and financial integration of modern economies have important consequences for macroeconomic policy. Policymakers have responded by embracing different approaches to policymaking. This paper briefly describes these alternative policy approaches as well as related empirical evidence. The paper argues that persistent success characterizes two of the three approaches described.

Toward an Open Economy: Evidence and Implications of Integration

The following facts provide evidence that economies are more open and that markets are increasingly integrated:[1] (1) ratios of imports and exports to GNP have significantly increased in countries like the United States (Cooper 1986); (2) the foreign presence in major domestic markets is rising (Frenkel and Goldstein 1991); (3) inflation rates among industrialized countries have converged; (4) interest rate differentials between the costs of domestic and offshore interbank funds have fallen dramatically (Frenkel and Goldstein 1991: 11; Goldstein, Mathieson, and Lane, 1991: 7–11); and (5) covered interest parity holds in many short-term financial markets (Goldstein, Mathieson, and Lane 1991: 7; Frankel 1991). While evidence pertaining to uncovered interest parity and real interest parity is more difficult to interpret, data concerning short-term financial markets seem to suggest that they are highly integrated and returns on longer-term debt

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[1]See for example, Richard Cooper (1986); Jacob Frenkel, Morris Goldstein, and Paul Masson (1990); Stanley Fischer (1988); and William Branson, Jacob Frenkel, and Morris Goldstein (1990).

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and equity instruments in various countries have shown increasing tendencies to move together (Goldstein, Mathieson, and Lane 1991: 8–10).

There are two key implications of increased integration: first, as markets broaden, and as specialization proceeds making the economy more complex, the price system becomes more important in coordinating economic activity. It has to allocate resources over a broader realm of activity. Second, integrated economies imply shrinking spheres of autonomy (or influence) for economic policymakers in various countries. Heightened interdependence limits the control and scope for conventional domestic policymakers. Markets increasingly constrain or discipline policymakers. The more integrated the economy, for example, the more quickly divergent policies impact exchange markets or capital flows, thereby constraining policymakers.

Alternative Approaches to Policy in an Integrated Environment

Given the lessened scope for policymakers in the wake of integration, what alternative policy options for managing the domestic economy in this environment are available? What are the appropriate policy frameworks for this environment?

Generally, there are three types of approaches to national economic policymaking in this environment: first, coordinating discretionary macroeconomic policymaking, an approach sometimes associated with the Group of Seven (G-7); second, policy competition among decentralized policymakers, and third, rule-based policy coordination.

Discretionary Macro-Policymaking

Those supporting the first approach, the coordination of discretionary macro-policymaking, believe that since this heightened international interdependence limits the scope for independent policy action, countries must coordinate policy to regain the potency of policymaking. In effect, proponents of this approach see and use policy coordination as a way to circumvent the constraints of exchange markets or capital flows. In their view, policy coordination is identified with coordination of aggregate demand. Aggregate demand is controlled and coordinated by discretionary adjustments of monetary and fiscal policy. The budget deficit is the key fiscal policy instrument for fiscal policy coordination.

Studies that have attempted to quantify the effects of macro-policy coordination have generally found its benefits to be quantitatively

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quite small.[2] Thus, little formal evidence supports this type of policy coordination (especially, that variety emphasizing the coordination of fiscal policy). A number of studies have examined attempts to coordinate macroeconomic policy[3] but researchers could only point to a few limited episodes of "successful" macro-policy coordination of this type. At times central authorities found it advantageous temporarily to join coordination efforts, but such coordination did not persist when the self-interests of these authorities conflicted with policy coordination goals. In sum, little, if any, evidence exists of lasting successes of this type of policy coordination, especially for the coordination of fiscal policy. There are a host of reasons why this type of coordination has not worked and cannot work.[4]

Policy Competition

The second approach to policymaking in the current integrated environment is policy competition among decentralized policymakers. According to this approach, capital mobility will induce policymakers of various countries to adopt competitive tax and regulatory policies that attract and keep capital. This will tend to promote harmonization of efficient tax and regulatory policies—a result that is not achieved by the coordinated decisions of centralized tax authorities but through the workings of the competitive process itself. This policy approach is fully compatible with the operation of the price mechanism and fosters regulatory experimentation and innovation as well.

Empirical evidence does exist supporting this policy approach. There are many examples of tax harmonization produced by decentralized tax competition, including the widespread individual and corporate tax reductions and tax reform that took place in the 1980s in both developed and less developed countries, documented, for example, by Michael Boskin and Charles McLure (1990) and Vito Tanzi and A. Lans Bovenberg (1990). These reductions followed neither

[2]See, for example, the review of this empirical literature discussed in David Currie, Gerald Holtham, and Andrew Hallett (1989), especially pp. 25–27. Several of these studies argue that persistent economic shocks and policymaker credibility can appreciably increase the value of coordination. See also David Currie, Paul Levine, and Nic Vidalis (1987); and Gomel, Saccomanni, and Vona (1990: 16–18).

[3]See, for example, Ralph Bryant and Edith Hodgkinson (1989: 2); Robert Putnam and C. Randall Henning (1989); Gerald Holtham (1989); Destler and Henning (1989): Wendy Dobson (1991); Yoichi Funabashi (1988); and Gomel, Saccomanni, and Vona (1990).

[4]The lack of success of this type of policy coordination can be attributed to a number of formidable obstacles, including: (1) differing policy objectives among governments; (2) disagreements as to how economies work and interact; (3) political and constitutional constraints on the bargaining process; and (4) important incentives of participants to renege on their agreements.

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coordinated plans nor centralized international agreement. Rather, they resulted from pressures of competition unleashed by the mobility of capital and commodities. A similar process has worked within the European Economic Community; a degree of tax harmonization has occurred among European product taxes, capital gains taxes, and corporate income taxes. Europeans are becoming increasingly sympathetic to this approach to harmonizing their tax and regulatory structures (Cnossen 1987: 45, 48–49; Giovannini and Hines 1991: 175–76; and Micossi 1988). Still another example is the degree of tax harmonization that has occurred among states in the United States (Eichengreen 1990). However, some critics argue that, in practice, this process of interaction between governments sometimes produces excessive exchange rate volatility and/or unnecessary capital flows. Two examples might include the process of deregulation in the face of deposit insurance or the performance of exchange rates under flexible rates regimes.

Rule-Based Coordination

The third approach to policymaking in the current integrated environment encompasses the adoption of common policy rules, common standards, or common legal conventions. Establishing through international agreements a certain common framework fosters exchange and improves upon the beneficial workings of the market-price system because credible "rules of the game" are crucial to its performance. The approach may involve bilateral or multilateral agreements establishing rules or removing restrictions to the international mobility of commodities, services, capital, or labor. Such rules would minimize tariffs, nontariff trade barriers, or capital controls. The approach may involve rules fostering uniform laws or common "rules of the game." Examples include harmonious bankruptcy, patent, or contract laws, as well as rules for property rights on clearing and settlement. The approach may also encompass international agreements on common standards. Accounting standards, measurement standards for weight, length, temperature, etc., and disclosure standards are examples of such common standards.

Establishing such common international rules or standards can foster trade and exchange by reducing uncertainty and costs of acquiring information and knowledge about product characteristics. Yet, although it can and will promote the workings of markets and the price system, standardization can be overdone if it prevents regulatory innovation and experimentation, fosters cartel powers and rents of regulators, or prevents competition.

From a rule-oriented perspective an argument may be developed favoring an international monetary standard. A credibly anchored fixed

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exchange rate system can serve as a standard of value and a standard of deferred payments. Not only does a well-anchored fixed exchange rate system foster price stability but it also eliminates both the well-known excessive volatility and the overshooting of exchange rates, thereby minimizing the variability and dispersion of many other prices and improving the working of the price system.

There are many examples of successful international standards or common policy rules providing supporting evidence for this type of policy approach. Some even argue that this is the only type of policy coordination that can persist over time.

Examples of Rule-Based Policy Coordination

General Agreement on Tariffs and Trade (GATT). GATT, an example of an international agreement to reduce tariffs, is one of the success stories of the post-World War II era. The coordination of tariff policy under the aegis of GATT is a rule-based form of policy coordination in which countries establish credible rules of the game. GATT, after all, is a set of legal rules. While many problems remain with GATT agreements, most economists agree that this rule-based form of international policy coordination has achieved considerable success.

International Monetary Standards. The international gold standard, or more recently, the Bretton Woods system, provides another example. This agreement established fixed, albeit adjustable, exchange rates, thereby effectively committing participating countries to common coordinated monetary policies and ensuring that price levels moved together. It was based on the dollar (theoretically with a noncirculating gold base). In short, this system involved common rules under which the price system would function effectively. While not without defects, the Bretton Woods system performed remarkably well over an extended period of time compared to post-Bretton Woods monetary arrangements:

- The volatility of both nominal and real exchange rates was substantially smaller under Bretton Woods (McKinnon 1990: 5; Giavazzi and Giovannini 1989: 54). Moreover, no exchange rate overshooting occurred.
- The volatility of commodity prices was significantly lower under Bretton Woods (Chu and Morrison 1984: 10).
- On average, levels and volatility of inflation were significantly lower under Bretton Woods (McKinnon and Robinson 1992: Tables 11.3, 11.4). And inflation in participating countries moved together rather than diverging (McKinnon and Robinson 1992: Figure 11.4).

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- The levels of volatility on both short- and long-term interest rates were lower under Bretton Woods (McKinnon 1990: 6, 8–9; McKinnon and Robinson 1992: Table 11.2).

The European Monetary System. Another example, the European Monetary System (EMS), performed well (until recently) because it had a stable German anchor. During the 10-year-period, 1979–89, for example:

- Both real and nominal exchange rate variability fell (Russo and Tullio 1988: 48; Guitain 1988: 11).
- Inflation rates converged and the dispersion of inflation fell (Russo and Tullio 1988: 48).
- Both short-term and long-term rates converged (Russo and Tullio 1988: 50).
- Devaluations became more infrequent.
- The system imposed discipline on various monetary authorities.

In short, for a decade, the EMS provided another example of a successful, rules-based coordination of monetary policy that worked to improve the performance of the price system.

The U.S. Constitution. The U.S. Constitution is another example of the successful adoption of common policy rules. Recognizing the many problems under the Articles of Confederation, state representatives met in Philadelphia in 1787 and agreed to a number of formal policy rules laid out in the Constitution (McDonald 1985: 154–57). In effect, these representatives agreed to coordinate important elements of economic policymaking. The Constitution created the largest free-trade area in the world at the time (McDonald 1985: 260; McDonald 1982: 58). In addition to eliminating restrictions to the mobility of capital, labor, and commodities across states, it established important property rights, standards, and a common currency area. These "rules of the game" fostered exchange and allowed the market-price system to coordinate economic activity.

More specifically, the Constitution established uniform property rights in the form of uniform bankruptcy, contract and patent laws (Article 1, Section 8), as well as uniform legal tender codes (Article 1, Section 8). It created congressional power to establish uniform standards of weights and measures (Article 1, Section 8) and standards by which to regulate the value of money (Article 1, Section 8). Furthermore, it prohibited states from coining money, effectively creating a common currency area. And it prohibited protectionist trade legislation among states, interstate barriers to trade (Article 1, Section 9), and "locally preferred" regulation of commerce.

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Other International Standards. Other examples of the adoption of common international policy rules or standards are the establishment of Greenwich Meantime, the metric system, the Morse Code, uniform maritime rules of the road, international public health agreements, and others. Thus, numerous examples exist of the successful adoption of common policy rules that have persisted over extended periods of time.

Conclusion

The evidence suggests that lasting, persistent success in coordinating market activity in an open economy cannot be achieved through discretionary policymaking (especially of the coordination of deficit-based fiscal policies). Virtually the only examples of persistent successful policy coordination or harmonization are what I described here as the policy competition approach and the common rules approach. Both approaches are fully compatible with the workings of the price system. Consequently, as the world becomes more integrated, these may be the only truly viable policy alternatives.

A pertinent question remains, however. In particular, when is it more appropriate to opt for an international standards or common rules approach and when is it better to foster policy competition? From the very brief and cursory look at the evidence, the answer seems to be that competitive policymaking appears to work in the areas of tax and regulatory issues. Common standards or rules appear to work for trade agreements, for international monetary standards and in certain other areas where standards are appropriate.

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The Future of Universal Banking

Georg Rich and Christian Walter

Universal banks have long played a leading role in Germany, Switzerland, and other Continental European countries. The principal financial institutions in these countries typically are universal banks offering the entire array of banking services. Continental European banks are engaged in deposit taking, real estate and other forms of lending, foreign exchange trading, as well as underwriting, securities trading, and portfolio management. In the Anglo-Saxon countries and in Japan, by contrast, commercial and investment banking tend to be separated. In recent years, though, most of these countries have lowered the barriers between commercial and investment banking, but they have refrained from adopting the Continental European system of universal banking. In the United States, in particular, the resistance to softening the separation of banking activities, as enshrined in the Glass-Steagall Act, continues to be stiff.

The purpose of this paper is to analyze the German and Swiss experience with regard to universal banking. We attempt to show to what extent that experience supports or refutes the arguments against universal banking frequently voiced in the Anglo-Saxon world. Since we are most familiar with the Swiss banking system, we rely heavily on our own experience. Based on this analysis, we draw various conclusions about the future of universal banking.

The remainder of the paper is divided into four parts. First, we discuss the salient characteristics of the German and Swiss banking systems, and attempt to rectify various misconceptions about universal banking. Second, we contrast the history of German and Swiss banking legislation with that of the United States. Third, we consider the

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arguments in favor of and against universal banking. Finally, we end with a concluding section on the future of universal banking.

Salient Characteristics of the German and Swiss Banking Systems[1]

Popular discussions of universal banking are often flawed by misconceptions about the characteristics of Continental European financial systems. The German system, in particular, is frequently portrayed as being dominated by large oligopolistic universal banks with branches all over the country. German banks are said to intermediate the bulk of financial flows, while domestic capital markets remain underdeveloped. Furthermore, emphasis is placed on the fact that German banks tend to hold equity stakes in industrial companies and, therefore, wield considerable influence on their management.

This characterization of the German banking system is overly simplistic and fails to do justice to the realities of universal banking. It is certainly true that in countries like Germany and Switzerland large universal banks with nationwide networks of branches play an important, if not dominant, role. However, this simplistic description omits crucial features of universal banking that tend to get lost in the public debate. Three such features are worthy of note:

- Even if legislation allows for universal banks, not all financial institutions choose to offer the entire gamut of banking services. Only the largest institutions tend to be truly universal banks, which coexist with smaller, specialized institutions. Moreover, universal banking may take on a variety of institutional forms.
- The importance of universal banks has tended to increase since the end of World War II. But the techniques employed for promoting universal banking have varied. In particular, there are substantial differences between Switzerland and Germany in this regard.
- Universal banking need not prevent capital markets from playing an important supplementary role in financial intermediation. The German and Swiss experiences also differ significantly in this respect.

Universal Banking and Specialization

Table 1 provides information on the structure of the German and Swiss banking systems. In both countries, financial institutions may

[1]See Francke and Hudson (1984), and Pozdena and Alexander (1992) for descriptions of the German financial system. A similar description for Switzerland is provided by Birchler and Rich (1992).

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TABLE 1

BANKING STRUCTURE IN GERMANY AND SWITZERLAND, 1991

	Number of Banks (End of Year)	Percentage Share of Banking Group in Total Assets (End of Year)	Commissions as a Percentage of Net Revenue
Germany			
Big Banks	4	9	26
Regional Banks	198	14	21
Government-owned Savings Banks	757	34	14
Savings Banks	746	20	14
Central Savings Banks	11	14	12
Cooperative Banks	3,158	15	16
Credit Cooperatives	3,154	11	14
Central Cooperative Banks	4	4	30
Private Banks	84	1	29
Branches of Foreign Banks	60	1	29
Other Financial Institutions	102	25	n.a.
Total	4,363	100	18
Switzerland			
Big Banks	4	49	47
Regional & Savings Banks	189	8	19
Cantonal Banks	28	20	21
Cooperative Banks	2	3	9
Private Banks	19	1	80
Branches of Foreign Banks	16	1	34
Other Banks	222	16	54
Finance Companies	112	2	32
Total	592	100	44

SOURCES: Deutsche Bundesbank (1992a: Tables 13, 22a; 1992b: 42–47), and Swiss National Bank (1992: Tables III, 1.1; 40.0–40.8).

be classified into broadly similar groups: big banks, government-owned savings banks, regional banks, cooperative banks, branches of foreign banks, and private banks. In addition, both countries feature one or two remaining groups of diverse and highly specialized institutions.

The group of big banks comprises institutions with nationwide branch networks, as well as an important international business. They are truly universal institutions involved in all aspects of banking. They play a leading role in financing foreign trade and industry. They are also heavily engaged in investment and trust banking. Most of the big German and Swiss banks occupy an important position in domestic and international securities markets. They act as leading underwriters of domestic and international securities issues. The big Swiss banks, in particular, are also well known for their role as international portfolio managers.

The regional banks, as their name indicates, normally confine their activities to specific regions. In Germany that group includes the subsidiaries of foreign banks. Regional banks tend to be more specialized than the big institutions. The largest German regional banks, however, have turned into truly universal institutions. They have spread to other parts of the country and have also penetrated foreign markets. They now operate nationwide branch networks, but remain "regional" in the sense that they continue to focus their business on their home region. Many of the large German regional banks are also authorized to engage in mortgage lending. In Switzerland most of the regional banks, in fact, are small savings banks heavily engaged in mortgage lending.[2] These banks do not play a significant role in investment banking and they are not active abroad.

In both Germany and Switzerland, government-owned banks account for a substantial share of total assets (Table 1). The majority of these banks were founded in the 19th century by municipalities or districts in Germany and by cantons in Switzerland. The purpose of these banks was, and is, to encourage saving by the local population. However, in contrast to private-sector savings institutions, government-owned banks must accept certain public-service functions, such as promoting the development of the local economy or assisting disadvantaged groups. In Germany, these banks are chartered by the *Länder* (states) and can only operate within their home-*Land* (state). Although the individual German government-owned savings banks can hardly be regarded as universal establishments, they operate central institutions

[2]In Germany, financial institutions may not grant mortgage loans unless they are authorized to do so. No such restrictions exist in Switzerland.

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(Landesbanken) placed at the level of the *Länder* and at the federal level. These central institutions initially were set up to provide payments services to their members, but later evolved into full-fledged universal institutions. Through these central institutions, the individual savings banks are able to offer universal banking services to their customers. Among the Swiss cantonal banks cooperation is less common. Only the largest cantonal banks come close to resembling universal institutions. They do play a limited role in underwriting domestic securities and in portfolio management, but are legally constrained to engage in foreign business.

Cooperative banks, like government-owned savings banks, are institutions focusing on the savings business. Although initially conceived as self-help organizations, which mainly accepted deposits from and lent funds to members of the cooperative, they gradually evolved into universal banks when they set up central institutions, as was done in Germany. In Switzerland, by contrast, cooperative banks remained less important, as indicated by their respective shares in total assets of the banking system (Table 1). Due to their small market share, Swiss cooperative banks have not expanded into universal banking to any great extent.

The remaining banking groups in Table 1 largely consist of specialized institutions involved in the most diverse lines of activity. In both Germany and Switzerland, private banks, whose importance has shrunk considerably, are active in portfolio management. Branches of foreign banks, though often part of a universal institution, typically also specialize. In Switzerland, they tend to concentrate on underwriting and portfolio management. Finally, in Germany, the category "other financial institutions" includes building societies, mortgage establishments, and other specialized institutions. In Switzerland, the groups of "other banks" and "finance companies," which include the subsidiaries of foreign banks, cover institutions involved in various activities, such as commercial banking, underwriting, securities trading, and portfolio management.

An analysis of bank earnings reveals further differences between the German and Swiss banking systems. Table 1 shows the share of commission income in net revenue, broken down by banking groups. Commission income covers fees obtained on such banking services as payments services, guarantees, foreign exchange and securities trading, underwriting, portfolio management, and financial derivatives. Aside from commission income, net revenue includes interest income on the banks' assets net of interest paid on the banks' liabilities. Therefore, institutions involved mainly in traditional commercial banking activities display a low ratio of commission income to net revenue.

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Investment and trust banks, by contrast, display a high ratio, while truly universal banks occupy the middle range.

Table 1 points to two striking differences in the structure of German and Swiss banks' earnings. First, German institutions, as a whole, resemble more closely traditional commercial banks than their Swiss counterparts. In Germany, the average ratio of commission income to net revenue is much lower than in Switzerland. The relatively high Swiss ratio reflects the important role played by Swiss banks in underwriting, securities trading, and portfolio management. Second, in Germany, that ratio displays a much smaller variability across the various banking groups than in Switzerland. In Germany it fluctuates between 12 to 30 percent as compared to a range of 9 to 80 percent in Switzerland. Thus, while German banks, on average, are less universal than their Swiss counterparts, universal banking in Germany is more evenly spread across the various groups of financial institutions than in Switzerland.

A high ratio need not imply that the group concerned specializes in investment banking. Unfortunately, the available data on Switzerland do not provide a detailed breakdown of commission income by sources. There is little doubt that Swiss banks derive their commission income mainly from four sources: foreign exchange trading, underwriting, securities trading in the secondary market, and portfolio management. Separate data are available on commission income gained from foreign exchange trading. They indicate that big banks and branches of foreign banks are more heavily engaged in foreign exchange trading than the other groups. However, the patterns revealed by Table 1 are not altered much if the foreign-exchange component is eliminated, although the ratio of commission income to net revenue, for the Swiss banking system as a whole, drops from 44 to 33 percent.

While some specialized Swiss institutions act as pure investment banks, they typically combine investment and trust banking under one roof. Many of the specialized Swiss banks operate as portfolio managers. They are members of the domestic stock exchanges and, thus, provide both brokerage and portfolio management services to their clients. In most cases, they do not participate to any great extent in underwriting, which is dominated by big banks. Consequently, the strategy of specialization pursued by many of the smaller Swiss banks does not fit the Glass-Steagall mould. Rather, it has resulted in a separation of traditional bank borrowing and lending from investment and trust banking.

In summary, the German and Swiss experiences indicate that many banks choose to specialize even if legislation does not place any constraints on universal banking. Specialized banks tend to be small

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institutions coexisting and competing with big universal banks. Although both the German and Swiss systems allow for specialization, there is little doubt that since the end of World War II, market forces have served to enhance the importance of universal banks and have permitted them to expand their sphere of influence.

The Growing Importance of Universal Banks

Despite the similarities between the German and Swiss banking systems, the trend toward universal banking has not taken the same form in both countries. In Germany, the shares of the various banking groups in aggregate assets, as shown in Table 1, has not changed much since the 1960s. In particular, the market share of the big German banks has remained relatively small as compared to that of their Swiss counterparts. Thus, in Germany, the trend toward universal banking did not increase the market share of big banks. Rather, as mentioned above, universality has been strengthened in two other ways: the larger regional banks have turned into truly universal institutions, and government-owned and cooperative banks through their central institutions have added universal features to their operations. Although the market shares of the various groups of banking institutions have not changed much, the number of German banks has shrunk substantially in the postwar period.

In Switzerland, universality was strengthened largely by big banks expanding their market share at the expense of smaller institutions. At the end of World War II, the big banks accounted for roughly 25 percent of aggregate assets. In 1991 that ratio has risen close to 50 percent of aggregate assets (Table 1), while regional and cantonal banks saw their market shares fall drastically. As a result, the big banks now occupy a dominant position in the Swiss financial system.

Universal Banking and Capital Markets

Many students of financial markets have pointed to the striking difference in the role played by nonbank financial intermediation in the United States and Germany (see, for example, Kregel 1992). In the United States, nonfinancial corporations raise the bulk of their required funds on the capital market.

Table 2 provides data on the capital structure of U.S. nonfinancial corporations outside the agricultural sector. It shows the shares of equity and various types of debt in total capital (sum of equity and debt). According to Table 2, U.S. nonfinancial corporations raised over 50 percent of their capital in the form of equity. Bonds are a far less significant source of finance, but their importance has increased since 1975. Loans from banks and other financial institutions, by

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TABLE 2

CAPITAL STRUCTURE OF NONFARM NONFINANCIAL CORPORATIONS[a] IN THE UNITED STATES
(Percent, End of Year)

	1975	1991
Equity[b]	67.5	53.4
Bonds[c]	10.8	15.7
Open-Market Papers	0.4	1.3
Mortgages	4.9	2.9
Bank Loans[d]	6.3	7.5
Other Loans[e]	1.0	3.2
Trade Debt	7.3	9.2
Other[f]	2.0	6.9

[a]Only nonfarm nonfinancial corporations are listed in the source given below.
[b]Equity computed as the net worth of nonfarm nonfinancial business.
[c]Includes both tax-exempt debt and corporate bonds.
[d]The figure for bank loans includes acceptance liabilities to banks as reported in the source given below.
[e]Includes foreign loans, nonbank financial loans, and U.S. government loans.
[f]Includes taxes payable, and miscellaneous liabilities.
SOURCE: Board of Governors of the Federal Reserve System (1992: 23–25).

contrast, only account for roughly 10 percent of total capital. Table 3 exhibits analogous data on German nonfinancial corporations. The important role played by German banks in lending to nonfinancial corporations is clearly revealed by that table. Bank loans account for over 40 percent of total capital. More than 60 percent of bank loans are provided in long-term form. Conversely, only about 25 percent of capital consists of equity, while bonds and short-term securities are an insignificant source of finance.

The patterns revealed by Tables 2 and 3 are mirrored by the equally striking differences in the composition of financial assets held by the ultimate lenders to nonfinancial corporations. Table 4 displays data on the structure of financial assets in the hands of U.S. private households, as well as U.S. pension funds and insurance companies. It testifies to the importance of stocks in the portfolios of both private households and institutional investors. Private households allocate 25 to 33 percent of their financial assets to deposits (including currency) and securities respectively, while the institutional investors favor securities.

In Germany, by contrast, private households place roughly 50 percent of their financial assets with banks and building societies, while their holdings of securities account for less than 25 percent of the

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TABLE 3

CAPITAL STRUCTURE OF NONFINANCIAL CORPORATIONS IN GERMANY
(Excluding Construction Sector, Percent, End of Year)

	1972	1991[a]
Equity	27.0	26.3
in Bank Portfolios	n.a.	2.6
Bonds	3.5	2.4
Short-term Securities	0.5	—
Bank Loans	46.2	42.9
Short-term	18.9	15.4
Long-term	27.3	27.5
Loans from Building Societies and Insurance Companies	3.8	2.8
Other	19.0	25.6

[a]Excluding the former East Germany.

SOURCES: Deutsche Bundesbank (1973: 56; 1993: 92). The percentages shown for the end of 1972 are calculated from revised data supplied by the Bundesbank. The percentages are based on outstanding stocks of securities, valued at market prices. The category "Other" covers liabilities vis-à-vis corporations, public authorities, social security funds and foreigners.

total (Table 5). In particular, stocks in the hands of German private households amount to merely 5.6 percent of the total, as compared to 23.8 percent for their U.S. counterparts. However, from 1975 to 1991, German private households increased somewhat the share of securities in aggregate financial assets. As far as institutional investors are concerned, a comparison of German and U.S. patterns is hampered by the fact that in Germany pension funds play a less significant role than in the United States.[3] The data in the last two columns of Table 5 reveal a pattern similar to that of private households, except that direct lending by institutional investors to the ultimate borrowers (mostly mortgage loans and loans to employers) is more important in Germany than in the United States.

In view of the structural differences revealed by Tables 2 through 5, the question arises whether the preponderance of bank-induced financial intermediation observed in Germany is characteristic for universal banking systems. Do universal banks inhibit the development of capital markets and nonbank financial intermediation? To answer

[3]In Germany, pensions are frequently provided directly by former employers or by plans set up by the former employer with insurance companies.

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TABLE 4

COMPOSITION OF FINANCIAL ASSETS OF PRIVATE HOUSEHOLDS, PENSION FUNDS, AND INSURANCE COMPANIES IN THE UNITED STATES
(Percent, End of Year)

	Private Households[a]		Pension Funds and Insurance Companies[b]
	1975	1991	1991
Stocks[c]	25.1	23.8	30.3
Corporate Bonds[d]	2.9	1.5	22.8
Securities of U.S. Government, U.S. Agencies, and State & Local Government[e]	7.4	9.8	20.9
Open-Market Papers	0.3	1.3	2.5
Loans	2.2	1.8	10.2
Currency and Deposits	36.0	26.0	5.5
Insurance and Pension Reserves	24.0	33.3	—
Other[f]	1.7	2.4	7.9

[a]Households include both personal trusts and nonprofit institutions. Since personal trusts are included in the total for households, there is no separate entry for them. Equity in noncorporate business is excluded.
[b]Covers public and private pension funds, life and other insurance companies.
[c]Includes mutual fund shares.
[d]Includes foreign bonds.
[e]Tax exempt securities are assumed to be state and local bonds.
[f]Includes security credit and miscellaneous assets.
SOURCE: Board of Governors of the Federal Reserve System (1992: 15–17).

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TABLE 5

COMPOSITION OF FINANCIAL ASSETS OF PRIVATE HOUSEHOLDS, PENSION FUNDS, AND INSURANCE COMPANIES IN GERMANY
(Percent, End of Year)

	Private Households		Pension Funds[a] and Insurance Companies	
	1972	1991[b]	1972	1991[b]
Stocks	8.4	5.6	9.8	15.8
Bonds	8.9	18.1	19.7	23.1
Bank Deposits	54.0	42.7	15.3	35.6
Deposits with Building Societies	7.8	4.0	—	—
Insurance	14.9	21.8	—	—
Loans	—	—	55.2	25.5
Other	6.0	7.9	—	—

[a]Only legally independent pension funds.
[b]Excluding the former East Germany.
SOURCES: Deutsche Bundesbank (1973: 56; 1993: 92). Percentages for the end of 1972 are calculated from revised data supplied by the Bundesbank. Securities are valued at market prices. "Loans" only cover the portion extended to nonbanks. Loans to banks are subsumed under "bank deposits."

this question, it is once again useful to compare the German and Swiss experiences.

Unfortunately, this comparison is complicated by various gaps in the Swiss data. It is possible to estimate the structure of the *increase* in capital of Swiss nonfinancial corporations over the period extending from the end of 1973 to the end of 1988. The following types of data are available on the major sources of corporate finance: (1) rough estimates of the increase in equity and bonds over that period, (2) stock data on loans of pension funds to nonfinancial corporations, and (3) stock data on bank loans to nonfinancial corporations for the period beginning with the end of 1977. Other sources of finance were probably unimportant.[4] Since the data from the various sources are not homogeneous, the percentages shown in Table 6 are based on the increase in equity, bonds, and pension-fund loans over the period

[4]Swiss nonfinancial corporations do not issue short-term securities such as commercial paper. A turnover tax on securities transactions which was partly eliminated on April 1, 1993, imposed high costs on the issue of short-term securities. It remains to be seen whether the modification of the turnover tax will breathe life into the Swiss money market.

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TABLE 6

CAPITAL STRUCTURE OF NONFINANCIAL CORPORATIONS IN SWITZERLAND
(Percent, 1973–88)

Equity	39.9 – 47.9
in Bank Portfolios	0.6 – 0.7
Bonds	14.8 – 17.1
Bank Loans	30.5 – 41.4
Loans from Pension Funds	3.9 – 4.5

SOURCES AND ESTIMATION METHOD: We used data assembled by Dominik Egli (1991) on issues of equity and bonds, net of conversions, by Swiss corporations over the period extending from the end of 1973 to the end of 1988. The data on equity include an estimate of cumulative retained earnings over that period. From Egli's estimate we deduct the increase in equity (including reserves) and bonds (excluding cash bonds), as reported by Swiss banks and finance companies (excluding cantonal banks and foreign-owned banks) in their balance sheets over the same period (Swiss National Bank 1989: Tables 18.6 and 18.7; 1974: Table 22). For loans from pension funds, we used the difference between stocks held at the end of 1988 and 1973. No data are available on stocks at the end of 1988. Therefore, we inserted the corresponding average for the end of 1987 and 1989 (Eidgenössisches Volkswirtschaftsdepartement 1976: 212, Table 2; Bundesamt für Statistik 1991: Table 4). These data represent borrowings of nonfinancial corporations from their own pension funds. For bank loans to nonfinancial corporations, we employed either the stock at the end of 1988 or the difference between the stocks at the end of 1988 and 1977 (Swiss National Bank 1978: 72; 1989: Table 33.4).

1973–88. Furthermore, for bank loans to nonfinancial corporations, we estimate the upper and lower bounds of the true increase over that period. The former equals the stock at the end of 1988, whereas the latter represents the increase over the period extending from the end of 1977 to the end of 1988. This procedure yields the percentage ranges for the four sources of corporate finance displayed in Table 6.

Interestingly, the capital structure of Swiss nonfinancial corporations looks like a mix of U.S. and German patterns. In Switzerland, the share of equity in total capital is lower than in the United States, but the two countries' shares of fixed income securities are about equal. Moreover, for the share of bank loans, the Swiss percentage figure is closer to German than U.S. levels.

Table 7 exhibits data on the composition of financial assets in the hands of Swiss private households and institutional investors. The data suffer from various defects listed in the legend to that table, but they should portray the structure of financial assets with reasonable

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TABLE 7

COMPOSITION OF FINANCIAL ASSETS OF PRIVATE HOUSEHOLDS, PENSION FUNDS, AND INSURANCE COMPANIES IN SWITZERLAND
(Percent, End of 1990)

	Private Households	Pension Funds and Insurance Companies
Stocks	15.1	10.0
of which Foreign	9.0	5.2
Bonds	16.6	30.8
of which Domestic Government	0.3	2.5
of which Foreign	14.3	4.0
Cash Bonds	5.2	7.2
Loans	—	36.2
of which Mortgage Loans	—	15.2
Bank Deposits and Fiduciary Accounts	25.6	11.9
of which Fiduciary Accounts	3.0	0.4
Insurance and Pension Reserves	36.8	—
Other	0.8	3.8

SOURCES AND ESTIMATION METHOD: Data on securities, including cash bonds, held by private households only cover the portion managed by domestic banks (Source: unpublished data collected by the Swiss National Bank). There are also households managing their securities on their own, but no data exist on the size of these holdings. Data on bank deposits and fiduciary accounts by private households are from Swiss National Bank (1991: Table 33.4). Claims of private households on insurance companies are assumed to equal the following items, as published in Bundesamt für Privatversicherungswesen (1992: Table 2.3.3): reserves, technical provisions and customers' claims on the surplus of life insurance companies. The estimate, thus obtained, is likely to overstate claims of private households because it includes claims of foreigners on domestic life insurance companies. Claims of private households on pension funds are assumed to equal capital (free and restricted) of these funds, as shown in Bundesamt für Statistik (1992: Table 5). For the securities holdings of insurance companies (life and casuality) and pension funds, see Tables 2.3.2 and 4 in the last two sources mentioned above. These two sources only contain the totals of stocks and bonds held by insurance companies and pension funds. The breakdown shown in Table 7 is estimated from the unpublished source mentioned at the outset. This source suggests that the bulk of securities held by Swiss insurance companies and pension funds is managed by domestic banks. For data on bank deposits and fiduciary accounts by insurance companies and pension funds, see Swiss National Bank (1991: Table 33.4).

accuracy. Once again, the Swiss patterns differ from those of Germany. As far as asset preferences of private households are concerned, there are greater similarities between Switzerland and the United States than between Switzerland and Germany. Swiss private households keep about 30 percent of their financial assets in the form of bank deposits, including fiduciary accounts and cash bonds, a share somewhat higher than in the United States, but considerably lower than in Germany. Cash bonds, which are issued by Swiss banks mainly to finance mortgage loans, must be subsumed under bank liabilities. However, in Switzerland, the private households' share of securities is lower than in the United States but, higher than in Germany. Moreover, private households in Switzerland display a strong preference for bonds, albeit not as strong as in Germany.

By contrast, there are marked differences between the asset preferences of Swiss and U.S. institutional investors. In Switzerland, institutional investors hold roughly 40 percent of their assets in the form of securities, as compared with over 70 percent in the United States. Conversely, loans by institutional investors to the ultimate borrowers are more important in Switzerland than in the United States. Bank deposits are also more important in Switzerland, but less so than in Germany.

The relative importance of Swiss capital markets is confirmed by Table 8, presenting data on the major stock exchanges of the three countries under review. Table 8 suggests that in Switzerland stock exchanges play a much larger role than in Germany. At the end of 1990, the market value of stocks, issued by domestic companies and listed on the major domestic stock exchanges, amounted to as much as 88 percent of GNP in Switzerland, as compared to 26.8 percent in Germany, and 49.6 percent in the United States. Consequently, the Swiss experience suggests that universal banking may be consistent with a well-developed domestic capital market. The evidence of Table 8 also agrees with our earlier conclusion about the relatively strong weight of commission income in the net revenue of Swiss banks.

Tables 3 and 6 also provide information on bank ownership of equity in German and Swiss nonfinancial corporations. In Switzerland the share of equity owned by banks is negligible, but even in Germany it is small. We do not know how the evidence of Table 3 agrees with the frequently expressed view that the participation of German banks in domestic industry constitutes an important phenomenon.[5] Be that

[5]Kregel (1992) argues that the official German data, as reported in Table 3, understate bank ownership of corporate equity. In Switzerland, banks are discouraged from acquiring controlling equity stakes in nonbank corporations. The capital-adequacy rules stipulate that such stakes be covered fully by the bank's own capital.

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TABLE 8

STOCK EXCHANGES IN THE UNITED STATES, GERMANY AND SWITZERLAND, 1990

	USA[a]	Germany[b]	Switzerland[c]
Number of Companies Listed (End of Year)			
Domestic	6,414[d]	649	182
Foreign	351	555	240
Market Value of Stocks of Listed Domestic Companies (End of Year)			
Billions of U.S. Dollars	3,105	343	167
Percent of GNP	49.6	26.8	88.0

[a]New York Stock Exchange (NYSE), American Stock Exchange (AMEX), and National Association of Security Dealers Automatic Quotation (NASDAQ).
[b]Stock exchanges in Frankfurt, Berlin, Bremen, Düsseldorf, Munich, Hamburg, Hannover, and Stuttgart.
[c]Stock exchanges in Zurich, Geneva, and Basle.
[d]Data for AMEX include foreign stocks.

SOURCE: Goldman Sachs (1991: 4,9,11,17,96,124,128).

as it may, there is little doubt that German and Swiss banks wield considerable influence over industry. Bank representatives sit on the boards of major domestic companies and vice versa. Moreover, in Germany, the *Depotstimmrecht*, that is, the right of a bank to represent the owners of shares held in bank-managed portfolios, is also an important control instrument. In Switzerland, the *Depotstimmrecht* used to be important too, but recent legislative reforms have curbed the banks' ability to throw their weight around corporate board rooms.

Some Historical Considerations

Until the early 1930s, the U.S. banking system incorporated crucial elements of universality. Many commercial banks engaged in investment banking activities. However, these banks were not organized along the lines of German- and Swiss-style universal institutions. They conducted their investment banking operations in legally separate securities affiliates.[6] The banking crisis of the 1930s provided the impetus for a drastic reform of U.S. banking legislation, including the passage of the Glass-Steagall Act of 1933. The resulting separation of commercial and investment banking has remained a feature of the U.S. financial system ever since.

In Germany and Switzerland domestic banks were also seriously afflicted during the Great Depression. The German government was forced to take over most of the big banks in order to forestall a complete collapse of the domestic banking system. However, these banks were reprivatized during the latter part of the 1930s (Francke and Hudson 1984: 7–13; Kregel 1992: 235–36). In Switzerland about 10 percent of the banks failed. As in the United States, the financial crisis resulted in major reforms of German and Swiss banking legislation. The German Banking Act (*Kreditwesengesetz*) of 1934 considerably strengthened bank supervision by establishing a single agency with broad supervisory powers over the financial system. In Switzerland the Banking Act of 1934 transferred the authority for supervising banks from the cantons to the federal government. However, in contrast to the United States, both Germany and Switzerland maintained their universal banking systems.

Why did Germany and Switzerland respond differently to the banking crisis than the United States? Examining the German experience, J.A. Kregel (1992: 235–36) argues that

> in difference from the U.S., the German banking crisis of the 1930s was not primarily a result of fraud or use of deposit funds for

[6]The National Banking Act was interpreted to imply that national banks could not operate their securities business directly (see Benston 1990: 25).

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> speculation in capital markets. It was the result of hyperinflation in the inter-war period and the extensive reliance on foreign borrowing to finance war reparations. The crisis was set off by an outflow of foreign and domestic funds.

The causes of the U.S. banking crisis, mentioned by Kregel, are those stressed by many contemporary observers. In the United States, the advocates of banking reform typically traced the origin of the crisis to massive losses at the securities affiliates of the commercial banks, due to fraudulent or reckless behavior and excessive speculation. In their view, the entire financial system was thrown in the abyss as these difficulties spilled over to the commercial banks. Barriers between commercial and investment banking, they maintained, would help to prevent future crises. In Germany, by contrast, the crisis stemmed from losses in the traditional lending business of the banks. It was magnified by the high indebtedness, notably vis-à-vis foreigners, of German industry. In Switzerland too, losses on loans were regarded as the principal cause of the crisis.

New research on the U.S. banking crisis of the 1930s has cast doubt on the stories told by contemporary observers. In a study of the investment banking activities of the national banks before 1933, Eugene White (1986) shows that institutions without securities affiliates had a much greater tendency to fail than those actively engaged in the securities business. Thus, the significance of losses arising from the banks' securities operations was probably exaggerated. As in Germany and Switzerland, it appears that the origins of the crisis must be sought mainly in the commercial banking practice of U.S. financial institutions rather than in their investment activities.

Furthermore, in a careful study of the debates preceding U.S. banking reform, George Benston (1990) demonstrates that many of the charges directed at pre-1933 U.S. universal banks were ill-founded. He points out that many charges, though legitimate, had little to do with universal banking. They pertained to fraudulent or irresponsible practices, flawed internal control procedures, and inadequate supervision of banks in general, rather than to specific problems arising from universality. Another set of charges identified by Benston concerned the difficulties associated with the particular institutional setup of U.S. universal banking, that is, with the existence of legally separate securities affiliates. And finally some charges referred to defects of universality as such. Since our study deals with the German and Swiss experience, it is these defects that are of particular interest. Broadly speaking, the critics of universal banks voiced four kinds of concerns:

- Commercial banks engaged in the securities business are liable to incur greater risk than institutions that stick to deposit taking

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and lending. Therefore, universal banks are prone to increa the likelihood of losses by their depositors.
- Because of the increase in risk, universal banks complicate th tasks of central banks in their capacity as lenders of last resort
- Universal banks are likely to be entangled in various conflicts o interest vis-à-vis their creditors and debtors.
- Universal banks, due to their size, may further the concentration of power and inhibit competition.

Possible conflicts of interest may arise from the fact that officials of universal banks may gather inside information from their loan departments on customers whose securities they underwrite. They may use that information to make inside profits on the sale of these securities. Universal banks also may encourage their debtors to fund bad loans by issuing securities. As underwriters of these securities, they may provide misleading information to potential buyers and thus shift credit risk to the general public. Finally, universal banks may try to increase profits from their securities business by providing misleading information on the quality of the paper offered to the public. In this way, they may induce unwitting depositors to purchase bad securities or they may unload bad securities on their trust departments.

In Germany and Switzerland, these alleged defects of universal banking did not loom large in the public debate on banking reform. The Swiss Banking Act of 1934 was conceived by Julius Landmann, an outstanding economics professor at the University of Basle. In the period 1910–14, Switzerland was shaken by a serious banking crisis that resulted in numerous bank failures. In response to that crisis, the Swiss government asked Landmann to work out a proposal for a federal banking act.[7] Since Landmann's report was highly controversial, the government declined to act on its recommendations. Instead, it kept his report secret for a lengthy period of time. His proposal was implemented only after another banking crisis had erupted in the early 1930s.

In his report, Landmann (1916: 32–36) attributed the banking crisis of 1910–14 to a variety of causes. They included flaws in the internal organization of banks, especially inadequate division of responsibilities among bank officials and poor internal controls. Landmann also uncovered various shortcomings in the lending practices of Swiss banks.

[7]Landmann (1910) also wrote a study on Swiss banking law for the U.S. National Monetary Commission that recommended establishing the Federal Reserve System.

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Many banks granted loans in regions in which they normally did not operate. Moreover, they often failed to diversify sufficiently their loan portfolios and tolerated overly large exposures to individual borrowers. They also engaged in excessive maturity transformation and did not exercise sufficient care in monitoring the interest-rate risk they incurred. Frequently, their own capital was inadequate to protect them against risks arising from their lending. History repeated itself two decades later as the banking crisis of the 1930s was triggered by the same malpractices that had afflicted the Swiss financial system in the period 1910–14 (see Urech 1944: 3–9).

Thus, Landmann (1916: 69) and other observers attributed the Swiss banking crises to flaws in the internal organization and in the lending practices of financial institutions rather than to shortcomings in their securities business. Nevertheless, Landmann (1916: 63–69) was aware of the problems that might arise from universal banking. He explicitly discussed the question of whether Switzerland should abandon universal banking and adopt the British system of separation. In his view, separation was ideally suited for a mature economy such as Great Britain, but not for a country like Switzerland that, in his time, was still in an early stage of industrial development. To improve the performance of universal banks, Landmann (1916: 94–112) proposed establishing a government agency, similar to the Security Exchange Commission (SEC), that would be empowered to oversee securities markets and to deal with such problems as conflicts of interest.[8] While Landmann's proposal for tightening bank supervision was eventually implemented, securities markets were left largely unregulated. Only recently did the Swiss government decide to propose legislation to parliament for improving supervision of securities markets.

Germany too experienced occasional debates about possible defects of universal banking. For example, in 1974, the federal finance minister commissioned a study of the various problems associated with universal banks, such as conflicts of interest and concentration of power resulting from their equity stakes in nonfinancial corporations. The study group concluded that the objections to universal banking, for the most part, were not borne out by the facts (Francke and Hudson 1984: 45–46).

[8]Complaints about conflicts of interest were voiced from time to time. See, for example, Schulthess (1934). Furthermore, Swiss corporations for a long time were notorious for their uninformative financial statements, a practice already criticized by Landmann (1916: 69–78). The quality of Swiss financial reporting is now improving.

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Are the Objections to Universal Banking Justified?

In the previous section we identified four major objections to universal banking. In his study of the Glass-Steagall Act, George Benston (1990: chap. 10) reviews critically these objections. In his view, the case for separation of commercial and investment banking rests on weak foundations. We can now supplement Benston's comprehensive analysis with a few observations drawn from the Swiss experience.

Riskiness and Lender-of-Last Resort Problems

Are universal banks prone to incur excessive risks and, thus, to jeopardize the stability of the financial system? Benston (1990: 149–59) examines various studies that attempt to answer this question by drawing on U.S. evidence. Most of these studies, he concludes, reject the view that universality enhances the riskiness of banking operations.

TABLE 9

CROSS CORRELATIONS OF VARIOUS NET REVENUE COMPONENTS OF SWISS BANKS
(Annual Logarithmic First Differences, 1950–91)

	IL	II	IC
IL	1		
II	−0.17	1	
IC	−0.03	0.32	1

SOURCE: See Table 1.

The available Swiss evidence leads to similar conclusions. Table 9 presents cross correlations between logarithmic first differences in various components of the Swiss banks' net revenue. The latter is divided into net interest income from loans (*IL*), other interest income (*II*), and income from commissions (*IC*). As we noted above, *IC* is not attributable solely to investment banking activities. A similar problem arises with regard to *II*. Nevertheless, the correlations between *IL*, on the one hand and *II* and *IC*, on the other, should shed some light on the riskiness of universal banking. If these correlations assume only a small positive or even a negative value, combining commercial and investment banking under one roof would actually decrease risk. As shown in Table 9, the two correlation coefficients assume slightly negative values. Thus, there is no evidence to suggest that in Switzerland universal banking increases risk.

The evidence from Table 9 is corroborated by the current structural changes in the Swiss banking system. As a result of the recent collapse of the real estate market, many Swiss banks are compelled to make

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provisions against bad mortgage loans. Regional and cantonal banks are particularly afflicted by these problems. For this reason, the number of regional banks is shrinking substantially, mainly as a result of mergers within that group or takeovers by bigger institutions. The big banks, by contrast, are weathering their real-estate problems without much difficulty, due to their ability to diversify risk among a wide range of activities.

Since universal banks are better equipped to diversify their risk than the specialized institutions, universality as such does not complicate the lender-of-last-resort role of central banks. However, problems may arise from the fact that universal banks are typically large. If large institutions run into solvency problems, central banks may be confronted with the dilemma of "too big to fail." In principle, these institutions should be closed, but such closures might send shockwaves through the entire financial system and impair its stability. Clearly, the "too big to fail" dilemma is not related to the universality of banks but to their size.

Conflicts of Interest

Universal banking may give rise to conflicts of interest that need to be taken seriously. It would not be difficult to find examples of conflicts of interest in the history of Swiss banking. Nevertheless, two reasons lead us to believe that in Switzerland conflicts of interest today create far less serious problems than in the past.

First, Swiss regulations of securities markets are being strengthened considerably. Insider trading is now a criminal offense in Switzerland. Furthermore, the government is proposing legislation that would guarantee transparency of stock exchange trading, as well as adequate financial reporting by listed companies. A second reason, in our view, is even more important than the first one. Market forces themselves support the legislative efforts for diffusing conflicts of interest and preventing other abuses in securities markets. For example, if a universal bank attempts to hide blunders in underwriting by shifting unsaleable securities to its trust department, its customers are likely to be confronted with relatively low returns on their portfolio investments. Competitors, including specialized banks, have an incentive to bid away customers from the low-performing universal institution. Thus, market forces tend to induce universal banks to eradicate conflict-of-interest problems.

This process is very much at work in Switzerland. It is fuelled by a number of new developments in domestic and international financial markets:

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- Institutional and individual investors place much greater emphasis on performance than in the past. Many investors today deal with a multitude of banks, including specialized institutions. They compare the returns on their various portfolios and penalize the low performers. The house-bank system, still in place in Germany, is not common in Switzerland.
- Price-fixing agreements and other cartel arrangements have been abolished in Swiss financial markets. Competition among domestic financial institutions is much more vigorous than in the past. The enhanced competition also keeps the big universal banks on their toes.
- As a result of the globalization of financial markets, Swiss banks must increasingly compete in international markets.

Although financial institutions are closely supervised in Switzerland, barriers to entry into the banking industry are not high. If big banks leave unexploited profit opportunities, new institutions may enter the market to fill these niches. Switzerland has also traditionally taken a liberal attitude towards the influx of foreign banks, who have invigorated competition in the domestic financial market.

Concentration of Power

Students of the German banking system frequently express concern about the concentration of power in the hands of the big domestic universal institutions. In Switzerland, these concerns are less pronounced even though the big Swiss institutions account for almost 50 percent of the domestic banks' aggregate assets. The intensification of competition and the regulatory changes mentioned earlier have curbed the power of the big Swiss banks.

A review of the literature (e.g., Benston 1990: 194–99; Pozdena and Alexander 1992: 571–75, 583) suggests that the critics of the German banking system tend to overstate the problems arising from the banks' influence on the economy. On the contrary, the evidence seems to support the view that the German system has promoted economic growth by enhancing the efficiency of the domestic economy. According to Pozdena and Alexander (1992: 574), German banks through their ability to monitor the management of nonfinancial corporations improve the allocation of credit. They also help to alleviate agency problems that would likely arise if ownership of stock issued by nonfinancial corporations were widely dispersed.

The Future of Universal Banking

We have argued that in Germany and Switzerland the importance of universal banking has grown since the end of World War II. Will

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this trend continue so that universal banks could completely overwhelm the specialized institutions in the future? Are the specialized banks doomed to disappear? This question cannot be answered with a simple "yes" or "no". The German and Swiss experiences suggest that three factors will determine future growth of universal banking.

First, universal banks no doubt will continue to play an important role. They possess a number of advantages over specialized institutions. In particular, they are able to exploit economies of scale and scope in banking. These economies are especially important for banks operating on a global scale and catering to customers with a need for highly sophisticated financial services. As we saw in the preceding section, universal banks may also suffer from various shortcomings. However, in an increasingly competitive environment, these defects will likely carry far less weight than in the past.

Second, although universal banks have expanded their sphere of influence, the smaller specialized institutions have not disappeared. In both Germany and Switzerland, they are successfully coexisting and competing with the big banks. In Switzerland, for example, the specialized institutions are firmly entrenched in such areas as real estate lending, securities trading, and portfolio management. The continued strong performance of many specialized institutions suggests that universal banks do not enjoy a comparative advantage in all areas of banking. As a matter of fact, a substantial body of research indicates that most big banks have already grown beyond the point at which further expansion in their market shares results in significant returns to scale or scope. On the contrary, a continued expansion is often detrimental to the banks' profitability as decisionmaking within the institution becomes bureaucratic and inflexible. Thus, even if legislation allows for universal banks, many financial institutions will elect to specialize. However, the pattern of specialization generated by market forces need not resemble the Glass-Steagall type of separation of commercial and investment banking. German and Swiss experiences strongly suggest that banking activities will be separated along different lines.

Third, universality of banking may be achieved in various ways. No single type of universal banking system exists. We have shown that the German and Swiss universal banking systems differ substantially in this regard. In Germany, universality has been strengthened without significantly increasing the market shares of the big banks. Instead, the smaller institutions have acquired universality through cooperation. They have set up central institutions conducting those banking activities that are subject to significant returns to scale and scope. In Switzerland, the cooperative approach has not worked as well as in

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Germany. The smaller Swiss institutions find it difficult simultaneously to compete with one another in some areas of banking and to cooperate in others. For this reason, in Switzerland the growth in universality has been associated with a substantial increase in the market shares of the big banks. It remains to be seen whether the cooperative approach will survive in an environment of highly competitive and globalized banking.

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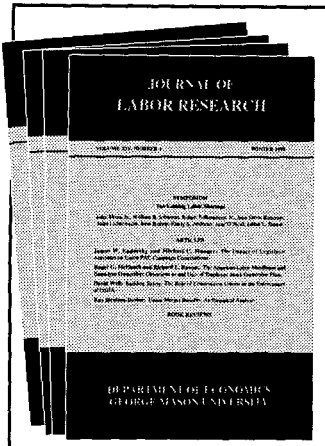

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Published quarterly by the Ohio State University Press
1070 Carmack Road, Columbus, Ohio 43210-1002 614/292-6930

One-year subscription: $40 Individual $85 Library $25 student

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(ISSN 0891-3811)

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—Rondo Cameron

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